The Market for Mergers and the Boundaries of the Firm*

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First Draft: July, 2003  
This Draft: September 20, 2005

Abstract

Mergers redraw the boundaries of the firm. In this paper, we relate incomplete contracts to empirical regularities in the market for mergers and acquisitions. We begin by empirically challenging conventional wisdom about mergers and acquisitions: high M/B acquirers typically do not purchase low M/B targets. Instead, mergers typically pair together firms with similar M/B ratios. To show why this occurs, we build a continuous time model of investment and merger activity that combines search, relative scarcity, and asset complementarity. Our model shows that the 'like buys like' empirical finding is a natural consequence of a prediction from the property rights theory of the firm; namely, that complementary assets should be placed under common control. A number of new empirical predictions emerge from our analysis. First, if asset complementarity is important, then we should see small differences in the M/B of targets and acquirers. It also predicts that the difference in M/B ratios should increase when discount rates are high and valuations are low. In additional tests, we show that both of these predictions are borne out by the data. Our findings suggest that the incomplete contracts theory of the firm is central to understanding the empirical regularities of the market for mergers and acquisitions.

*We would like to thank Boyan Jovanavic, Charles Jones, Denis Gromb, Gordon Philips, Stefano Rossi, Tano Santos and S. Viswanathan for useful discussions, and workshop participants at Columbia, Duke, the 2004 EFA meetings, the National Bureau of Economic Research Summer Institute, the Federal Reserve Board New York, the Stockholm School of Economics, 2005 AFA meetings, University of Maryland, SUNY Buffalo, SUNY Binghamton, Tuck School of Business, 2005 Econometric Society World Congress, William & Mary, Utrecht School of Economics and Texas Christian, University of Virginia. Any errors are our own.
Abstract:

Mergers redraw the boundaries of the firm. In this paper, we relate incomplete contracts to empirical regularities in the market for mergers and acquisitions. We begin by empirically challenging conventional wisdom about mergers and acquisitions: high M/B acquirers typically do not purchase low M/B targets. Instead, mergers typically pair together firms with similar M/B ratios. To show why this occurs, we build a continuous time model of investment and merger activity that combines search, relative scarcity, and asset complementarity. Our model shows that the ‘like buys like’ empirical finding is a natural consequence of a prediction from the property rights theory of the firm; namely, that complementary assets should be placed under common control. A number of new empirical predictions emerge from our analysis. First, if asset complementarity is important, then we should see small differences in the M/B of targets and acquirers. It also predicts that the difference in M/B ratios should increase when discount rates are high and valuations are low. In additional tests, we show that both of these predictions are borne out by the data. Our findings suggest that the incomplete contracts theory of the firm is central to understanding the empirical regularities of the market for mergers and acquisitions.
The boundaries of the firm are constantly being drawn and redrawn in the market for corporate control. In 2003 alone, over $500 billion in US merger activity occurred in over 8,200 transactions.\(^1\) This merger activity should reflect the importance of the placement of the boundaries of the firm. The goal of this paper is to bridge the gap between the theory of the firm and empirical evidence on mergers, and demonstrate the significance of the theory of the firm for understanding empirical regularities in the market for mergers and acquisitions.

One of the most well-established stylized facts about M&A activity is that the typical merger involves an acquirer with high asset valuations purchasing a target with low asset valuations. This is commonly interpreted as evidence in favor of a ‘Q-theory of mergers,’ in which mergers involve redeploying the assets of underperforming targets towards more profitable uses under the better management of the high-performing acquirer.\(^2\)

This paper challenges this conventional wisdom with a fresh look at who buys whom. Our theory tells us to examine the target and acquirer M/B ratio relative to other firms in the industry. Our empirical analysis shows that mergers bring together firms with remarkably similar M/B ratios. While the average M/B for an acquirer is slightly higher than the average for a target, the spread is typically less than one-sixth of a standard deviation in industry M/B. Bidders from high M/B deciles acquire other high decile targets; low decile bidders acquire other low decile targets. This pattern holds even after making industry adjustments. Thus, instead of ‘high buys low’ describing most mergers, we show that ‘like buys like’ is the central stylized fact surrounding merger activity and we provide a theory as to why.

Figures 1 and 2 illustrate the striking nature of this pattern. Figure 1 plots the distribution of the difference in market-to-book ratios between acquirers and targets and shows that a large fraction of transactions cannot be described as high buying low. In Figure 2 we test our central proposition by examining the bivariate distribution of acquirer and target market-

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\(^1\)Source: Mergerstat Review. Data include US and Cross-border transactions.

\(^2\)This idea has its foundations in Manne (1965) who argues that low value, badly managed firms will be bought by better managed firms. It is also an extension of Tobin’s Q theory of investment: if mergers are simply another form of investment then high M/B firms should invest by buying the assets of those firms that have low opportunities, and hence low M/B ratios. Recent work by Jovanovic and Rousseau (2002) puts this idea into a dynamic context to generate waves of activity. They show empirically that when M/B dispersion is high (implying a lot of room for the high M/B firms to improve the low M/B firms) then merger activity increases. This also suggests the Q-theory is at work.
to-book ratios. With acquirers on the left horizontal axis and targets on the right axis, the
eight of the graph represents the merger activity between each M/B decile. The distinct ridge
running along the diagonal of the graph shows just how much of the merger activity occurs
between firms with similar M/B ratios.

This ‘like buys like’ result is surprising when viewed through the lens of existing theory.
No current theory suggests any reason for the M/B of targets and acquirers to be so similar.
The theories of agency (Jensen, 1986), hubris (Roll, 1986), transaction costs (Coase, 1937),
or even simple beliefs in the potential for synergies, suggest limited patterns in M/B. They
do not imply convergence of bidder and target market/book ratios.\(^3\) Theories of misvaluation
(Rhodes-Kropf and Viswanathan (2004) and Shleifer and Vishny (2003)) suggest target and
acquirer M/Bs are high on average, but the theories do not predict bidder/target similarity in
M/B ratios. And the q-theory of mergers (Jovanovic and Rousseau, 2002) actually suggests the
opposite result: the highest M/B firms should acquire the lowest. It is reasonable to assume
that hubris, agency or q-theory are partial or even complete motivations in some transactions.
However, since they cannot explain the pattern in M/B ratios that we observe in the data,
these theories do not seem to capture the overriding motivation for mergers.

Thus, we provide a new theory of mergers. Our theory combines search, scarcity, and the
matching of assets to show that M/B ratios of merging firms naturally tend to equate when
the merging firms have potentially complementary assets. Our paper demonstrates the small
target/acquirer differential in M/B is a natural consequence of one of the key predictions from
the property rights theory of the firm of Hart and Moore (1990) and Hart (1995); namely, that
complementary assets should be bound together under common ownership. Thus, the data
suggest that mergers are the process through which complementary assets are joined into a
single firm.

At the core of the model is a continuous time version of a Diamond-Mortensen-Pissarides
search model joined with a basic neoclassical investment model. There are three key ingredients
in our analysis.

\(^3\)There exist many theories of mergers, for example Gorton, Kahl, and Rosen (2005) suggest they are a defensive
mechanism, but none that we know of suggests a matching in M/B.
The first two ingredients are search and scarcity. In our model, firms initiate standard investment projects. At the same time, firms also search for Pareto-improving asset combinations with other firms. In our model, firms cannot contract on the creation or distribution of the surplus generated by the asset combination: placing assets under common control is the only way to realize the synergies from asset combinations.

When firms find an acceptable partner, they then bargain over the available surplus from merger. Whether a firm accepts or rejects a particular negotiation depends on whether it prefers the terms of the current offer to the expected net gains from waiting, which in turn are determined by the likelihood of future merger opportunities, as well as the expected surplus from future transactions.

Thus, the M/B ratio contains two parts, one from the stand alone value of the firm and one from the net present value of future merger activity. The NPV in the stand alone firm arises from the skill or quality of the characteristics inherent to a firm. However, the NPV related to merger arises from the relative bargaining power of the merging firms, not from any inherent investment opportunities they bring to the newly merged firm. This is because unlike investment, a merger must be negotiated. Therefore, the benefit each party receives depends on their negotiating position, which in turn depends on each firm’s ability to locate another merger partner. Since both firms are necessary for the merger, the firm with the relatively more scarce assets will more easily locate another merger partner and therefore garner more of the merger gains. Thus, greater relative scarcity leads to higher ex ante M/B ratios.

The third ingredient is complementarity. We assume that gains from the merger are related to the firms’ compatibility or complementarity with one another. That is, mergers will create greater surplus if the partners are a ‘better match’ along one or more dimensions. For example the best pharmaceutical company can do more with the best new drug than the second best pharmaceutical can do. Thus, the second best pharmaceutical firm could buy the best new drug firm but would have to give up a larger fraction of the synergy. The compatibilities that we are suggesting could arise along any dimension: better production, better technology, better culture, are just a few possibilities. This element of our analysis builds on work by Becker (1981), Kremer (1993), Burdett and Coles (1997), and is related to Shimer and Smith.
The fact that firms look for complementary partners does not directly imply that firms will have similar M/B ratios. We show that each firm trades off their desire to merge with a better partner with the endogenously reduced bargaining power they will have in such a merger. In equilibrium, if complementarity is important, successful mergers will exhibit a high degree of matching. The best targets and the best acquirers have the best outside opportunities and create the most synergies. They endogenously choose to search for each other and therefore, in equilibrium firms who have the highest M/B ratios in their respective industries will choose to merge.

In our theory, relative scarcity determines who gets more surplus from the merger. Complementarities cause similar firms to merge with one another.

The assumption that merging firms have complementary assets arises from Hart and Moore (1990), Hart (1995) and the incomplete contracting literature. When there are significant complementarities between assets then simultaneous ownership by one firm reduces the hold-up problems and under-investment that results from the incomplete contracting. If this idea is important then a shock that increases the complementarities across firms should lead to merger activity. Such a shock may simply be the invention of a new technology like the internet or a new way to develop drugs (think of advances in biotechnology).

Two key predictions emerge from our analysis. First, our model predicts small differences in the relative M/B rank of targets and acquirers. As Figure 2 shows, this prediction is borne out by the data. Second, our model predicts that the difference in M/B ratios between merging firms should increase when discount rates are high and valuation levels are low. As Section V shows, this too is borne out by the data. Thus, the theory offers a guide: when thinking about the motivation behind mergers, we must focus on the traits that produce complementarities between partners. The data seem to reflect the idea that firms search for complementary partners and the market expects for firms to a large extent to share the gains from merging. Overall, our work suggests that incomplete contracts play an important role in determining the boundaries of the firm and therefore, who should merge.

The balance of the paper is organized as follows. First, we explore the stylized facts
surrounding merger activity. This is presented in Section I. Next, we build a model of merger activity based on search and scarcity. This is presented in Sections II and III. In Section IV, we analyze the role that asset complementarity plays in search. Then, in Section V we re-examine the empirical evidence to test the predictions of the model. Section VI concludes.

I  Do High Value Acquirers Buy Low Value Targets?

This section revisits the conventional wisdom that the typical merger involves an acquirer with a high asset valuation purchasing a target with a low asset valuation. This basic finding is discussed in a great deal of prior empirical work, including Servaes (1991), Rau and Vermaelen (1998), Martin (1996), Loughran and Vlij (1997), Lang, Stulz and Walkling (1989), Andrade, Mitchell and Stafford (2002) and others. In their survey paper, Holmström and Kaplan (2001) argue that corporate governance issues led to the merger waves of the 80s and 90s. Their work implicitly squares with the ‘high buys low’ idea inasmuch as firms with poor corporate governance have low market values and are taken over by higher valued bidders. Typically this result is couched as evidence for favorable asset redeployment; i.e., that high quality managers are overtaking poorly run firms.

Our theory tells us to revisit the relative market-to-book question by reexamining the empirical evidence on mergers and acquisitions. We examine the data before developing the model in order to generate interest and an understanding from the reader as to why we think a new theory of mergers is needed.

Our data include 3,400 merger transactions that were announced after 1980 between publicly listed bidders and targets in the United States. The merger data come from Securities Data Corporation’s Mergers&Acquisitions database; these data are merged with CRSP and Compustat to calculate log market-to-book ratios.4

Figure 1 depicts the density of the difference in market-to-book valuations for bidders and targets. Positive values correspond to ‘high buys low’ transactions; these occur roughly 60% of

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4We impose a three-month time lag between the date of the accounting and market information and the announcement of the merger to make sure that our measurements of the market-to-book ratio are not polluted by the announcement. For the exact details of our calculation, see Rhodes-Kropf, Robinson, and Viswanathan (2005).
the time. The plot shows that the mean value of the difference is positive, which indicates that on average, high market-to-book acquirers purchase lower market-to-book targets. However, the region to the left of the origin on the x-axis corresponds to the roughly 40% of the time in which the market-to-book of the acquirer is below that of the target.\(^5\) This ‘low buys high’ result echoes findings in Rhodes-Kropf, Robinson, and Viswanathan (2005).

To explore this issue more deeply, we examine the joint distribution of acquirer and target Market-to-book ratios. Rather than simply examining the difference, examining the bivariate distribution allows us to see which types of firms are most often involved in mergers, which speaks directly to the question of who buys whom.

In Table 1, we group the population of bidders and targets into bins according to annual breakpoints of the distribution of market-to-book for all NYSE traded firms.\(^6\) The \(i,j^{th}\) cell in Table 1 reports the frequency of mergers occurring between targets in decile \(i\) and bidders in decile \(j\). The breakpoints are recomputed annually to reflect changes in the distribution of market-to-book ratios for all NYSE firms. Thus, any clustering that appears in the table is not a result of time-series clustering of merger activity.

The table illustrates a high degree of correlation between bidder and target m/b ratios; Pearson’s \(\chi^2\) test for independence of bidder and target m/b ratios has a value of 854.91, with an associated p-value of 0.00. In fact, the mean difference is \(\frac{8}{10}\) of a decile, meaning that the average transaction couples bidders and targets that are no more than one decile apart in the distribution of m/b ratios.

The table illustrates several interesting features of merger activity. First, merger activity seems to cluster down the main diagonal. This is the ‘like buys like’ diagonal. This means that in many cases, bidders and targets come from nearby points of the market-to-book distribution. The prevailing wisdom that high buys low is borne out by the fact that most mergers lie below the main diagonal; these correspond to mergers in which the acquirer is in a higher M/B decile than the target. This indicates that, if anything, bidders have slightly higher market-to-book ratios than targets, but that their asset valuations are generally quite similar. This table

\(^5\)These figures match Andrade, Mitchell, Stafford (2001), who report that roughly 2/3 of transactions involve an acquirer with a higher \(q\) than its target.

\(^6\)The breakpoints were obtained from Ken French’s website.
shows why most research has focused on the ‘high buys low’ result as acquirers do tend to have slightly higher market-to-book ratios than targets. However, this table also suggests that something is driving firms with similar market-to-book ratios to merge.

Thus, Table 1 motivates our theoretical analysis as it indicates that mergers may exhibit assortative matching. Instead of seeing firms with disparate valuations merging, we find that firms with similar valuations merge with one another. This holds even though mergers occur at times when the average industry Q-dispersion is high (Rhodes-Kropf, Robinson, and Viswanathan, 2005).

To explore this idea further, Table 2 reports the average bidder/target M/B spread by transaction type. The column labelled ‘Mean Scaled M/B Difference’ reports the bidder/target difference as a fraction of the within-industry standard deviation of M/B for the year of the transaction. For example, if mergers occurred between an acquirer that was one standard deviation above the mean acquiring a firm that was one standard deviation below the mean (a prototypical ‘high buys low’ transaction) the scaled difference would equal two (200%).

In fact, the scaled difference is a paltry 14% when averaged across all transactions. When the acquirer’s M/B exceeds that of the target, the scaled difference is only 77% of a standard deviation on average. This occurs in roughly 62% of the sample. The remaining 38% of the sample has a scaled difference of negative 89% of a standard deviation.

The third bank of numbers in Table 2 splits the data according to whether ‘high buys high,’ ‘low buys low,’ etc., where we gauge whether bidder and/or target were above or below their industry median values in a given year. When both are below the industry median, the scaled M/B spread is quite small, only 2% of an industry standard deviation. When high buys high, the difference is again quite small, although larger: it rises to 11.46% of a standard deviation. These low values support the idea of assortative matching, but naturally control for the fact that mergers may be occurring within or across industries at a point in time. Only when we examine transactions that involve bidders and targets on opposite sides of the median line do we find scaled M/B differences greater than 1. And it is important to note that these transactions are relatively uncommon: the most common transaction type is for both bidder and target to be above industry median (high buys high). The second-most common type is
for both firms to be below the industry median.

We hasten to add that the results that we show here are not isolated to a particular point in time, nor are they confounded by industry classification. As table 3 demonstrates, there is no obvious clustering of the low buys high result in a given year. In particular, our results are not driven by what happened in the late 1990s, or by the merger characteristics of the 1980s.

Indeed, recent empirical evidence in Maksimovic and Phillips (2001) is consistent with our view. They show that in a substantial fraction of mergers the target firms’ plants are more efficient than those of the acquirer. In these cases, the productivity of the acquirer’s plants subsequently increases. Their findings suggest that asset redeployment from low $q$ to high $q$ firms need not be the driving force behind mergers even if mergers are driven by efficiency considerations.

The analysis of the entire distribution of market-to-book ratios shows that the empirical phenomenon is less clear than conventional wisdom would suggest. While it is true that a comparison of means indicates that the M/B for acquirers is higher than targets, the fact is that most of the time both firms have high M/B. Modest, but consistent, average differences in M/B between bidder and target mask the fact that most of the time ‘like buys like.’ This pairing of firms with similar valuations implies that mergers exhibit assortative matching as predicted by our theory.

In light of this new evidence on who buys whom in mergers and acquisitions, our next task is to develop a model that squares with these facts and which generates new predictions. The model is discussed in the next three sections. In section V, we return to the data to empirically explore more predictions of the theory.

II The Model

The model focuses on firms from two different industries, A and B, with two different types of assets, $K_A$ and $K_B$. For now, this will be the only difference between firms, however, section

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7Strictly speaking, it is not important for the model that the two firms be in different industries. It is only important that a firm cannot inexpensively convert its assets from one type to another. Throughout the paper we use ‘different industry’ and ‘different type’ interchangeably to convey the idea that a firm of one type cannot obtain the other type assets unless it acquires them from that type of firm.
IV will allow for different subtypes within each industry (such as high and low quality assets). Both firms produce output $y$ according to the production technology

$$y_i = z_i K_i^\alpha.$$  \hfill (1)

The parameter $z_i$ represents the firm’s production skill and can be interpreted as management quality or ability. This parameter is constant across states and over time. For simplicity, neither firm’s capital stock depreciates. The production parameter $\alpha \in (0, 1)$ implies decreasing returns to scale, which in turn guarantees that the capital stock is determinant. The particular choice of production function allows simple closed form solutions but does not drive any results.

The price of output is exogenously determined and normalized to 1. The appropriate discount rate is $r > 0$; therefore, the quantity $Y_i \equiv \frac{y_i}{r}$ represents the capitalized value of the infinite stream of future output.\(^8\)

We will allow continuous and frictionless adjustment of the capital stock. Thus, the capital stock is always set optimally. The cost of one unit of capital is normalized to one dollar.

If firms merge then the management ability parameter becomes $z_M$, where $M$ denotes the merged firm. After the merger is consummated, the joint production function becomes

$$y_{AB} = z_M (K_A^\alpha + K_B^\alpha).$$  \hfill (2)

For example, if mergers are occurring for Q-theoretic reasons then good management should apply its expertise to the bad firm and $z_M = \max [z_A, z_B]$, or if great management talent complements other great managers then maybe $z_M = z_A * z_B$, but any $z_M$ function is possible. The simple assumption that a merger alters only the $z$ parameter will not drive any result. Overall the form of the production function is of limited importance as the key results will depend on general changes in output due to the merger rather than on specifically how output changes.\(^9\)

\(^8\)We could also include future investment opportunities without qualitatively altering our results.

\(^9\)For example, $y_{AB} = z_M ((K_A + K_B)^\alpha)$ would not alter the general conclusions; nor would a changing $\alpha$, etc.
There are gains from a merger if

\[ y_A + y_B < z_M (K_A^{*\alpha} + K_B^{*\alpha}) - r (K_A^* + K_B^* - K_A - K_B), \]  

where \( K_i^* \) is the optimal capital stock chosen if the merger occurs. Thus, gains from merger are more likely if \( z_M \) is larger.

There are two states of nature, the No Merger state (NM) and the Mergers are Possible state (MP), \( \Sigma \in \{ \Sigma^{NM}, \Sigma^{MP} \} \), with associated state intensities \( \lambda^{NM} \) and \( \lambda^{MP} \). Since time evolves continuously, at each instant, the probability of remaining in state \( \Sigma \) over the next time interval \( \Delta \) is \( e^{-\Delta \lambda^\Sigma} \). The model begins in the state \( \Sigma^{NM} \), which means that no profitable merger opportunities are available. Specifically, management ability is assumed to be such that \( z_i > z_M \forall i \).

If the economy is in the \( \Sigma^{NM} \) state, there is probability \( 1 - e^{-\Delta \lambda^{NM}} \) that a positive shock will occur to \( z_M \). If a shock occurs, the state switches to \( \Sigma^{MP} \), and profitable merger opportunities are available. This shock captures the idea from Gort (1969) that exogenous factors, such as the discovery of a new technology or production process, create periods of organizational flux.

We assume that firms do not merge before the shock in preparation for the benefit because they are unaware of which type of assets they will need when the shock occurs. It seems reasonable that firms did not try to locate an internet partner in the 80’s before the internet was invented. The nature of a shock is such that we do not know what form it will take until it occurs.

This shock allows a possible benefit from joining the assets of firm A and firm B. After the shock we will assume that, \( z_M \) is large enough to ensure condition (3) holds. We assume that the state of nature, the value of \( z_M \) and whether the shock has occurred are common knowledge to both firms.

It is important to note that the increase in firm output only occurs if a firm A and a firm B merge. Firms cannot contract on the creation or distribution of the surplus generated by the asset combination: placing assets under common control is the only way to realize the synergies from asset combinations. Furthermore, if a firm remains a stand alone entity and
simply invests in more assets, then \( z_i \) remains the same as before the shock. The idea is that firms develop different kinds of assets. The synergies in a merger occur because of the complementary nature of the assets of different firms. For example, an inventor may have a new product and another firm may have the assets that market and distribute. While we assume the frictionless adjustment of capital of type \( A \) for any firm \( A \), we assume that type \( A \) firms cannot create the assets of type \( B \).

Let \( \pi_{NM}^i \) represent the present value of firm \( i \) in the No Merger state. This value includes an expectation over all possible future states of the world. As noted above it is possible that the state jumps to a state where Mergers are Possible (\( MP \)). When mergers are possible we assume that firms must search for a suitable partner. The delay in finding a partner represents the actual time firms must spend looking for a partner as well as the significant time spent in due diligence to ensure the match is viable. Let \( \pi_{MP}^i \) represent the present value of firm \( i \) in the Mergers are Possible state before they have located a potential partner. If a firm locates a potential partner then they must negotiate the terms of the deal. If the deal is consummated then on the announcement of a completed deal a firm’s value changes to \( \pi_{M}^i \), where \( \pi_{M}^i \) represents the expected value of a merger to firm \( i \). If a deal cannot be reached then firms continue to search for another potential partner. Thus, their value remains at \( \pi_{MP}^i \). At any time during this search process the state may return to the No Mergers state and then the value of firm \( i \) would return to \( \pi_{NM}^i \). We will develop this search and negotiation more fully below.

Figure 3 depicts a game tree for the model. It shows how the economy can move from the no merger state to the merger state. Once in the merger state, mergers can either occur or not occur, depending on whether merger partners are found and can agree on a deal.

**A. Investment When No Mergers Are Possible**

The world begins in the No Mergers state (\( NM \)). As long as this state persists, each firm chooses its investment, \( I_i \), to solve

\[
\max_{I_i} \left[ (K_i + I_i + \Delta z_i(K_i + I_i)^{\alpha})e^{-r\Delta} - I_i \right],
\]

(4)
where the subscript $i$ represents either A or B. This expression describes the value of the firm as the value of assets in place, plus the value of the production that will occur over the interval $\Delta$, minus the required investment. Since investment is frictionless, the capital stock always satisfies

$$K_{i}^{NM*} = \alpha - 1 \sqrt{\frac{r}{z_i \alpha}},$$

where the $NM*$ signifies that this is the optimal capital choice in the No Mergers state.

During any small moment of time, $\Delta$, each firm earns $\Delta z_i (K_{i}^{NM*} \alpha)$. Over this interval a shock may or may not occur. Let $\pi_{i}^{NM}$ represent the expected value of the No Merger state, and let $\pi_{i}^{MP}$ represent the expected value if the state is such that Mergers are Possible. The expected value of the firm in the No Mergers state can be written as

$$\pi_{i}^{NM} = [e^{-\Delta \lambda^{NM}} \pi_{i}^{NM} + (1 - e^{-\Delta \lambda^{NM}}) \pi_{i}^{MP} + \Delta z_i (K_{i}^{NM*} \alpha)e^{-r \Delta}].$$

This equation simply expresses the value of the firm in the No Mergers state as the discounted expected value of the firm in each future state (the first two summands), plus interim production.

To solve for the expected value in the No Merger state (NM) we must find the expected value in the Mergers are Possible state (MP). This requires us to examine the search a negotiation process. However, to understand negotiations we must first examine the benefits that would arise from a merger.

### B. The Gains from Merger

After the merger, the merged firm chooses its capital stock to solve

$$\max_{K_A, K_B} [\Delta z_M ((K_A + I_A)\alpha + (K_B + I_B)\alpha)e^{-r \Delta} - I_A - I_B + (K_A + K_B + I_A + I_B) e^{-r \Delta}].$$

The change in $z$ changes the optimal amount of each type of asset to the following:

$$K_{i}^{M*} = \alpha - 1 \sqrt{\frac{r}{z_M \alpha}},$$

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where the $M*$ signifies that this is the optimal investment in assets of type $i$ post Merger. We assume nothing changes in a firm in the periods after the merger, therefore the capital stock will remain the same for all future periods. Thus, the value of the merged firm is

$$z_M((K_A^{M*})^\alpha + (K_B^{M*})^\alpha) \begin{pmatrix} \alpha \\ r \end{pmatrix}.$$  \hspace{1cm} (9)

The optimal capital stock in the state where Mergers are Possible, but before any merger has occurred, is the same as in the No Merger state. That is, $K_i^{NM*} = K_i^{MP*}$. For now, we assume that firms cannot commit to a non-optimal level of capital post merger negotiations (whether or not the merger occurs) in an attempt to change the piece of the pie they receive. We will show in equilibrium (see proof of Proposition 1) that even if firms could commit to a non-optimal level of capital they have no incentive to do so. Thus, the value of the merged firm is the value of the output at the optimal investment level minus the cost of the increased investment.

$$s \equiv z_M((K_A^{M*})^\alpha + (K_B^{M*})^\alpha) - (K_A^{M*} + K_B^{M*} - K_A^{MP*} - K_B^{MP*}).$$ \hspace{1cm} (10)

The set of possible agreements is $\Pi = \{ (\pi^M_A, \pi^M_B) : 0 \leq \pi^M_A \leq s \text{ and } \pi^M_B = s - \pi^M_A \}$, where $\pi^M_i$ is the share of the merged firm to player $i$ ($i \in \{A, B\}$). For each $\pi^M_i \in [0, s]$, $\pi^M_i$ is the expected profit player $i$ obtains if an agreement is reached and a merger occurs.

In equilibrium, if a firm finds a partner it is possible to strike a deal as long as the utility from a deal is greater than the outside opportunity for both firms. If a firm rejects a merger partner then they remain in the Mergers are Possible state with expected value $\pi_i^{MP}$. Thus, $\pi_i^{MP}$ represents the utility from continuing to search and also the disagreement utility.

To determine how firms share the surplus generated by the merger we must decide on a model for the negotiations. While many different choices for the model of negotiations will work for our purposes, the simplest is the Nash bargaining solution, which in this case is just the solution to

$$\max_{(\pi^M_A, \pi^M_B) \in \Pi} (\pi^M_A - \pi^{MP}_A)(\pi^M_B - \pi^{MP}_B).$$ \hspace{1cm} (11)
The well known solution to the bargaining problem is presented in the following Lemma.\textsuperscript{10}

\textbf{Lemma 1} \textit{In equilibrium the resulting merger shares for firms A and B are}

\[ \pi^M_A = \frac{1}{2}(s - \pi^M_B + \pi^M_A) \quad \text{and} \quad \pi^M_B = \frac{1}{2}(s - \pi^M_A + \pi^M_B), \]

\textit{where the } \pi^M_i \textit{are the disagreement expected values and } s \textit{is defined by equation (10).}

With this understanding of the negotiation and merger we can now look at the state when mergers are possible and examine the search process.

\textbf{C. The Search for a Merger Partner}

To explore the process by which potential partners locate one another and agree on a merger consideration, we combine the Nash bargaining model with the classic search model of Diamond-Mortensen-Pissarides (for examples see Diamond (1993), Mortensen and Pissarides (1994), and for a review see Petrongolo and Pissarides (2001)).\textsuperscript{11} This allows for a negotiated outcome that depends on each party’s ability to locate another suitable merger partner.

If firms must search for a partner, we must define the probability that they locate one. We assume that the measure of firms with the assets of firm A is \( M_A \) and the measure of firms with the assets of firm B is \( M_B \). As is standard in search models, we define \( \theta \equiv M_A/M_B \). This ratio is important because the relative availability of each type of firm will determine the arrival rate of merger opportunities and therefore influence each firms bargaining ability. This fraction represents the \textit{relative scarcity} of each type of asset. If \( \theta \) is high there are many more firms with type A assets than type B, and vice versa.

Given the availability of each type of firm, the number of negotiations per unit of time is given by the matching function \( \psi(M_A, M_B) \). This function is assumed to be increasing in both arguments, concave, and homogenous of degree one. This last assumption ensures that the arrival rate of merger opportunities depends only on the relative scarcity of the assets, \( \theta \).

\textsuperscript{10}The generalized Nash bargaining solution is a simple extension but adds no insight and is omitted.

\textsuperscript{11}For a complete development of the model see Pissarides (1990). Our exposition follows this work. This combination was recently used by Inderst and Müller (2002) in examining venture investing.
which in turn means that the overall size of the market does not impact each firm in a different  

manner. Each individual firm experiences the same flow probability of a match. Thus, the  

arrival rate of a merger opportunity is a Poisson process. The arrival rate of a merger is  

$$\psi(M_A, M_B)/M_A = \psi(1, \frac{M_B}{M_A}) \equiv q_A(\theta),$$ 

(13)  

for firm A. By the properties of the matching function, \(q_A'(\theta) \leq 0\), the elasticity of \(q_A(\theta)\) is  
between zero and unity, and \(q_A\) satisfies standard Inada conditions. Thus, firm A is more likely  
to meet an available firm B if the ratio of type A to type B firms is low. From firm B’s point  
of view the arrival rate of mergers is \(\theta q_A(\theta) \equiv q_B(\theta)\). This differs from the viewpoint of firm  
A because of the difference in relative scarcity of their assets. \(q_B'(\theta) \geq 0\), thus Firm B is more  
likely to meet an available firm A if the ratio of type A to type B firms is high.

During any short period of time, \(\Delta\), there is a probability that firm A finds a merger  
partner, \(\Delta q_A(\theta)\) and a probability that firm A does not find a partner, \((1 - \Delta q_A(\theta))\), and must  
continue the search. During this search period there is also the probability that the Mergers  
are Possible state ends. This happens because of another technological shift that eliminates  
the usefulness of any more combinations of assets A and B. As noted above, the intensity of  
the Mergers are Possible state is \(\lambda_{MP}\), so the probability that mergers are still viable after a  
search of time \(\Delta\) is \(e^{-\Delta \lambda_{MP}}\). If the Merger are Possible state ends then each firm receives the  
expected value that they originally achieved at the beginning of the model in the No Merger  
state, \(\pi_{i}^{NM}\).

We assume that the measure of each type of firm is unchanging. Therefore, \(\pi_{i}^{MP}\) is the  
same at any point in time. Formally, this stationarity requires the simultaneous creation of  
more firms with assets like those of firm A and B to replace those that merge. Let \(m_i\) denote  
the rate of creation of new type \(i\) firms. Stationarity requires the inflows to equal the outflows.  
Therefore, \(m_i = q_i(\theta)M_i\). We can think of these new firms as coming from spin-offs of other  
combinations of assets that are no longer synergistic or from fundamental firm creation. In  
the context of a labor search model, this assumption would be highly controversial, since labor  
models are focused on the rate of unemployment. There is no analog for mergers, since we are
not interested in the ‘rate’ that firms stay unmerged. Indeed, none of our results depend on this simplification as we could have inflows arise only from spin-offs.

Given the discount rate \( r \), the disagreement utility of firm A is defined by

\[
\pi^M A = \Delta q_A(\theta) e^{-\Delta \lambda^M} \pi^M A e^{-r \Delta} + (1 - \Delta q_A(\theta)) e^{-\Delta \lambda^M} \pi^M A e^{-r \Delta}
\]

\[
+ (1 - e^{-\Delta \lambda^M}) \pi^N M e^{-r \Delta} + \Delta z_A (K^N M^*)^\alpha e^{-r \Delta}.
\]

This simply expresses the value of the firm in the Mergers are Possible state as the discounted expected value of the firm in each future state, plus interim production.

The model is now completely defined and we have enough information to solve for both the market values and the endogenous market-to-book ratios.

## III Relative Scarcity and Equilibrium M/B

Up to this point, we have added nothing about matching, incomplete contracts or asset complementarity. In fact we have not specified much about the functional form for output after the merger. All we have assumed is that each partner has their own \( z_i \) before the merger and the combined firm has a resulting \( z_M \). This setup is meant to capture a broad array of ‘reasons’ for merging, such as Q-theory \( (z_M = Max[z_A, z_B]) \) or potentially some asset complementarity \( (z_M = z_A * z_B) \). Before we add matching we will show the solution to the basic model and a few propositions that follow. This will help us to understand the endogenous nature of the M/B ratios and the impact of scarcity. Then, in the next section, we will add the potential for matching.

A firm’s M/B reflects their stand alone opportunities plus the expected gains from the merger even before the merger occurs. But a firm’s M/B depends not on the total gain from the merger, but rather on the share that firm will receive. We show how the total merger gain is split depends on the relative scarcity of the assets each firm brings to the merger. This establishes the notion of relative bargaining power that will be important when we think about what kind of partner a firm should try to find.
The first proposition provides the complete solution to the model.

**Proposition 1** Assuming condition (3) holds, expected profit is given by:

\[
\pi_{NM}^i = \frac{1}{\lambda_{NM} + r} \left( \lambda_{NM} \pi_{MP}^i + rY_i \right), 
\]

\[
\pi_{MP}^i = \frac{(2D + q_j(\theta)) Y_i + q_i(\theta) (s - Y_j)}{2D + q_i(\theta) + q_j(\theta)},
\]

\[
\pi_{M}^i = \frac{(D + q_i(\theta)) (s - Y_j) + (D + q_j(\theta)) Y_i}{2D + q_i(\theta) + q_j(\theta)},
\]

where \( D = r\lambda_{MP} + \lambda_{NM} + r \), \( i \neq j \), \( \forall i, j \in \{A, B\} \).

**Proof.** See appendix. ■

These solutions are intuitive: they are simply weighted averages of the possible future outcomes. If, for example, the No Mergers state persists indefinitely (\( \lambda_{NM} \to 0 \)) then the firms expected profit would just be \( Y_i \), the present value of future output as a stand-alone entity. The expected value after a merger has occurred, \( \pi_{M}^i \), or the expected value in the Mergers are Possible state, \( \pi_{MP}^i \), are just a weighted average of the surplus remaining after the other firm receives his stand alone value, \( s - Y_j \), and the firms own stand alone value, \( Y_i \).

The weights of course depend on the firms’ relative bargaining powers, which in turn depend on the ability to find another partner in time and on the opportunity cost of waiting.

Knowledge of the expected profit from each possible outcome leads directly to the next proposition that tells us how each firm’s share in the merger is affected by their scarcity.

**Proposition 2** The negotiated share of the combined firm that each firm receives is larger the more scarce their assets.

**Proof.** See appendix. ■

This proposition shows that the more scarce a firm’s assets the greater its bargaining power because it can more easily locate another merger partner. Thus, its share of the merged entity is larger.
A. Endogenous Market-to-Book Ratios

Since we have determined how the synergies from the merger will be shared and how this will effect the expected value in all states of the world, we can examine the Market-to-Book ratio. The Market-to-Book ratio at any point in time is the present value divided by its equilibrium capital stock. It is easy to see that the market values and thus the market to book ratios pre merger increase if the probability of a merger increases.\footnote{The probability of a merger increases if the persistence of the No Mergers state decreases ($\lambda^{NM}$ increases) or the persistence of the Mergers are Possible state increases ($\lambda^{MP}$ decreases).} The central message of Proposition 3 is that firms’ M/B ratios before a merger are not only affected by the value of investment opportunities they bring to the future merger, but by their relative bargaining power. This bargaining power depends on their ability to locate another partner, i.e., the firm’s relative scarcity.

**Proposition 3** Increasing the scarcity of a firm’s assets increases the probability that firm is in a merger, increases the share of the synergy they receive and increases their M/B ratios in all states (assuming the synergy is positive).

**Proof.** See Appendix. ■

This proposition demonstrates our first key idea as it shows us that the reflection of future merger activity in M/B ratios depends on the relative scarcity of the firm’s assets. It tells us that the relationship between the M/B ratios of acquirers and targets could be anything: high buys low, low buys high, or like buys like, as it depends on the relative scarcity of the merging firms.\footnote{Maksimovic and Phillips (2002) make a related point. They model how the boundaries of the firm change with respect to the decision to operate in multiple segments, depending on the firm’s productivity and demand shocks. Their model does not distinguish between the mergers and purchases of plants and capacity from other firms. Their model implies that following a positive demand shock better managed firms purchase assets from firms managed by less able managers, but due to differences in firm size, the relation between the market to book ratios and firm efficiency are not uniquely specified.} Essentially, in our analysis there are two parts to M/B: an investment Q and a merger Q. Since mergers must be negotiated, greater relative scarcity leads to higher ex ante M/B ratios.

The model to this point has established an important foundation: we have created a basic model of mergers with endogenous ex-ante M/B ratios that accounts for investment, search,
and scarcity. This platform could be used to examine a number of interesting ideas. We use it here to examine the ideas of substitution and complementarity in mergers.

B. Relative Scarcity and Q-theory (Substitutes)

This model foundation and our emphasis on scarcity is not at odds with the standard Q-theory rationale for mergers. In fact, standard Q-theory logic is a special case of the model we have developed thus far. In standard thinking, the firm with the greater investment opportunities has the higher M/B because the net present value of these opportunities are impounded into its current price. If mergers are just another form of investment then higher M/B firms should merge with lower M/B firms. But what if it were the case that many firms had great management and great ideas, but there were only a few firms with the assets needed to implement these ideas? The good managers would then compete to buy the relatively more scarce assets. Ultimately the firm with scarce assets and no ideas would acquire most of the surplus from the merger. Ex ante the market would realize this and award the firm with no investment ideas the higher M/B. We are not suggesting that this is a likely world. Our theory lays bare the fact that the standard q-theory rationale makes the implicit (and reasonable) assumption that managerial talent in the bidder is relatively more scarce than any assets brought to the table by the target.

Therefore, if mergers are about the redeployment of assets to better uses then there should be a large differential between the target and acquirer M/B. In fact, as we have shown, the differential is small. Proposition 3 shows that the only way to make current theories consistent with a small M/B differential is to assume that bidders and targets are equally scarce. We see no obvious economic justification in any current theory for such an assumption. Thus, we propose a new way to think about mergers. Why is the M/B of acquirers slightly larger than targets? Better management is indeed a scarce asset, it is just not the only asset. The Q theory of mergers is not wrong, it is just part of a larger story; a story that includes matching.
IV Matching with Complements

If one type of asset complements another type then a high quality firm may be better off merging with another firm with high quality assets rather than trying to redeploy poorly performing assets. For example, consider the best new product firm. Should they look to merge with the best marketing and distribution firm? It seems natural that this would be the best match. No asset is replacing another, but there is a clear potential for the sum to be greater than the parts. When Cisco buys a technology startup, are they redeploying underperforming assets? We think a better description is that they are looking for a firm who has the best new technology that will most complement their own. In any arena complementarities are about the ability of each part to enhance the total; good food is made better with good wine and good wine is made better with good food. Thus, we would rather drink our finest selection with a gourmet meal and have table wine with a lasagna. Note that any meal is made better with better wine, but we don’t typically choose to improve a basic meal with stellar wine and improve a weak wine with wonderful food. Instead total utility is improved by matching the the quality of the wine and food. We are suggesting that a similar idea may hold in mergers; total output may be greatest when the best in one area match with the best in another.

To implement the concept of complements in mergers we extend the model developed in the previous sections by specifying a complementary merger production function and incorporating some of the ideas in Burdett and Coles (1997). Within industry A or B we now assume that there exists a subset of types. Thus, we partition the measure of type A and B firms into subcategories. For simplicity we assume each of the $n$ subcategories are equally likely. (This does not affect our results but simplifies the analysis.) A firm from any subcategory will be denoted by a subscript $k$ or $h$ on A or B, where $k$ and $h$ are elements from the set $N = \{1, ..., n\}$ which represents the set of $n$ subcategories. Thus, when a type A firm locates a potential type B merger partner there will be a probability $\rho \equiv 1/n$ that the type B firm is of any particular subtype, $B_h$. We will assume that this is the same as from firm B’s point of view. That is, when B finds an A partner there is a $\rho$ chance that firm A is any particular subtype, $A_k$. The number of subcategories of firms is determined by the number of dimensions on which
firms can differ. For a given number of dimensions $d$, the number of subcategories $n$ is $n = 2^{d-1}$.

Our naming convention will give the lowest number to the firm with the ‘best’ (largest $z$) assets of that subtype.

If mergers are about complements then output, $y_{AkBh}$ is such that

$$y_{AkBh} + y_{AkBh} \geq y_{KhBh} + y_{AkKh},$$

for all $K, H \subseteq N \bar{k} = Max[K]$ and $\bar{h} = Max[H]$ and $\bar{k} = Min[K]$ and $\bar{h} = Min[H]$. That is, total (social) output is greater if firms get together with others with similar quality assets. The best with the best and the worst with the worst produce more than if the best try to help the worst. Condition (18) is sometimes referred to as supermodularity (see Becker (1981)).

Note that if condition (18) holds this does not ensure that type 1 firms will match with type 1 firms, only that it would be pareto-improving for them to do so. The possibility that firms endogenously sort and merge based on type is called assortative matching and it requires supermodularity. Shimer and Smith (2000) have shown that in general assortative matching in a search model with our assumptions requires low enough search costs. We will use this idea here to show how the possibility of assortative matching on assets shows up endogenously in M/B ratios before the merger.

Rather than stay unnecessarily general we will assume a simple functional form that implements the idea of complementarity. We assume that $z_M = z_{AkBh} = z_{Ak} * z_{Bh}$ and that $z_i > 1$. Many function forms would deliver our result but this choice will easily and clearly demonstrate the impact of complementary mergers.\footnote{General proofs, without this simplification, are available from the authors.}

The addition of subtypes changes very little about the model. Investment, $K_{Ak}^{M*}$, and the synergy, $s_{AkBh}$, now depend on the subtypes of the merging firms therefore equations (9) and (10) must include subscripts $k$ or $h$ on each A and B. The expression for the profit in the No Mergers state also changes little. The No Merger profit can be expressed just as it is in Equation (6) with the addition of a subscript $k$ or $h$ representing the subtypes. The equilibrium of the bargaining in a Merger can also be expressed similarly to Lemma 1, Equation (12); it...
is necessary only to change notation to recognize that profits and synergies now depend on
the subtype of the merging firms. \( \pi_i^M \) is changed to \( \pi_i^M(j_h) \) to recognize that the profits of a
merger depend on the subtype of firm \( i \) and the subtype of firm \( j \), where \( i \neq j \), \( i, j \in \{A, B\} \).
Also \( s \) is changed to \( s_{ik,jh} \) and \( \pi_{i,k}^M \) to \( \pi_{i,k}^{MP} \). The difference between this extension and the
original problem arises in the profit from the Mergers are Possible state which is also a firm’s
disagreement utility. Equation (14) the disagreement utility of a type A firm now becomes

\[
\pi_{A_k}^{MP} = \left[ [\Delta q_A(\theta) \left( \sum_{h \in N} [\rho \max (\pi_{A_k}^M(B_h), \pi_{A_k}^{MP})] \right) + (1 - \Delta q_A(\theta))\pi_{A_k}^{MP}]e^{-\Delta \lambda^{MP}} \right] \\
+ \pi_{A_k}^{NM}(1 - e^{-\Delta \lambda^{MP}}) + \Delta z_{A_k} (K_{A_k}^{NM \ast})^\alpha e^{-r\Delta}.
\]  

The difference in this and equation (14) is in the brackets in the first term. This is the sum
of the profits when each subtype of partner is located times the probability of that subtype,
where the max determines if a merger is consummated or the firms continue to search. This
summation and max function are the key additions to the model due to the multiplicity of
types. The expected profit from searching for a partner now depends on all the different types
of partners a firm may find.\(^{15}\)

The first step in demonstrating the effect of greater matching on M/B ratios is the following
lemma, which describes the conditions under which assortative matching will hold.

**Lemma 2** If

\[
2D [s_{ik,jh} - Y_{jh} - Y_{ih}] + \rho q_j(\theta) [s_{ih,jh} - s_{ih,jh}] < \rho q_i(\theta) [s_{ik,jh} - s_{ik,jh}],
\]  

for all \( k \neq h, k, h \in N, \forall i \neq j, i, j \in \{A, B\} \), then assortative matching will occur.

**Proof.** See appendix. ■

If condition (20) holds for a given \( N \), then we say that firms are in the assortative matching
regime. If so, firms will merge only if they have the same ‘quality’, i.e., their \( d \) dimensions
match and they belong to the same subcategory. This result is similar to Burdett and Coles
(1997) who focus on marriage and find that in equilibrium only men and women from the

\(^{15}\)The equation that represents the merger value from a type B firm’s point of view is parallel and omitted.
same ‘class’ marry.\footnote{Eckhout (1999) looks at a very general set up and shows existence and uniqueness.} If Condition (20) holds for a finer partition $N$ (i.e., for a larger list of characteristics $d$), then we say that the degree of assortative matching has increased.

Assortative matching in our context requires the supermodularity of synergies to be large relative to the opportunity costs of searching. Thus, for example, $s_{A_1B_1} + s_{A_2B_2}$ must be significantly greater than $s_{A_1B_2} + s_{A_2B_1}$. If mergers are complementary and condition (18) holds, then $s_{A_1B_2} - s_{A_2B_2} < s_{A_1B_1} - s_{A_2B_1}$. Therefore, if there were no costs to continuing to search and the types were equally scarce then we would be guaranteed assortative matching \textit{a la} Becker (1973). However, there are two effects which alter the willingness of differing types to consummate deals.

The first effect relates to $2D [s_{i_kj_h} - Y_{j_h} - Y_{i_k}]$. The expression in brackets is the gain from a merger between firms $i_k$ and $j_h$, which is positive as long as the synergies are positive. Thus, if type $k$ and type $h$ firms do generate synergies it pushes them toward accepting a deal, and more synergies lead to a greater chance of a deal. This effect becomes more important the more costly it is to continue to search (larger $D = r \frac{\lambda_{MP} + \lambda_{NM} + \rho}{\lambda_{SM} + \rho}$). With high search costs the current deal looks better than going back to searching. Thus, if $\lambda_{MP}$ or $r$ increases, or $\lambda_{NM}$ decrease, then a deal between any two types of firms is more likely to occur.

The second effect relates to the scarcity of the type A and type B firms. The more scarce the type A firm is the greater $q_A(\theta)$ is. The greater $q_A(\theta)$ the more bargaining power the firm has and the more the firm benefits from waiting for another firm with which it will produce great synergies because the firm will get all the extra production. And $\rho$ is the probability a firm is of a particular subtype. The greater this probability the more important the relative scarcity effect becomes.

Lemma 2 essentially says that it must be worthwhile for a firm to continue to search for a partner who matches on $d$ dimensions or they will simply accept a merger with the first partner they find who matches on $d - 1$ dimensions. Lemma 2 shows that as long as condition (20) holds firms will match. Increasing the number of dimensions over which firms match increases $s_{i_kj_h}$. So, as long as condition (20) holds, firms will increase the number of dimension on which they match. If firms are not matching on a dimension that is worth the search costs, then
all firms could be made better off by searching on that dimension. Thus, firms endogenously decide the number of dimension over which they choose to search. If there are more dimensions that may be marginally beneficial but are not worth the cost of searching, then they occur in mergers only by happenstance.

This brings us to the central point of the paper. The relative market-to-book ratios of the firms that merge depends on why the firms are merging. If mergers are generally about substitutes then firms will search for partners with quality most different from their own. However, if mergers are about complements then this will be reflected in firm’s exante M/B ratios in the following way.

**Proposition 4** If $z_{AkB_h} = z_{Ak} * z_{B_h}$ and condition (20) holds, then firms’ M/B ratios will exhibit rank-ordering: type A firms with the largest M/B will merge with the type B firms with the largest M/B, while type A firms with the second largest M/B will merge with the type B firms with the second largest M/B, and so forth.

**Proof.** See appendix. ■

This endogenous outcome arises because firms trade-off their desire to merge with a better partner with the reduced bargaining power they would have in such a merger. In equilibrium mergers that complete will match on multiple characteristics and this will endogenously result in similar exante M/B ranks, as the market recognizes this will occur exante. The markets’ expectations are reflected in the exante M/B ratios. Thus, the potential for a socially optimal outcome that arises from complementarities in merger partners impacts bargaining power and the choice of partner and through that mechanism endogenously pushes the M/B rank differential of completed deals toward zero.

Thus, if mergers are about substitutes then firms would choose to merge with the type most unlike them and the M/B of merging firms would be far apart. However, if mergers are mostly about complements then would should expect the M/Bs of merging firms to be similar. Clearly, some of each is occurring in the world. However, the data suggest that complements seem to be quite important in mergers.

The question then that naturally arises is why might we think mergers are about substitutes
or complements. The Q-theory of mergers provides the logic behind substitute mergers. And, as we discuss next, complements in mergers arise from standard thinking about incomplete contracts. Incomplete contracting is only one possible motivation for complements in mergers. We use it here because it follows from ideas about the boundaries of the firm that should relate to mergers. However, we want to be clear that the model and empirical predictions stem from the idea that mergers may be about complements and not from the underlying logic behind complementary mergers.

A. Incomplete Contracts and Complementary Assets

One of the central predictions of Hart and Moore (1990) and Hart (1995) is that in a world of incomplete contracts, highly complementary assets should be contained in a single firm. This suggests that firms with complementary assets should be more willing to pay the costs of merging to gain the benefits associated with concentrated ownership.

As we have stated in the introduction and the model setup, incomplete contracts enter our model in the following way. We assume that when two parties are paired, they cannot contract on the provision and division of the surplus created by combining their assets. The only way to capture the synergies is to place the assets under common control.

One way to arrive at this reduced-form representation of mergers is to assume, in the spirit of Williamson (1985), Grossman and Hart (1986) or Hart and Moore (1990) and others, that the realization of synergies involves relationship-specific investments. Firms that chose to contract with each other instead of merging would later face hold-up problems as either firm could threaten to search for another partner. This would lead to underinvestment in relationship specific objectives, such as quality, along a particular dimension on which firms could match.

Following Hart and Moore (1990), these incomplete contracting problems are most severe between assets that are highly complementary. This implies that firms with the highest degree of complementarity have the strongest incentive to merge, since the opportunity cost of underinvestment is highest between them.\(^\text{17}\)

\(^{17}\)See Tirole (1999) for an interesting summary of the incomplete contracting literature.
To incorporate this logic into our model we introduce the potential for firms to match along a number of distinct dimensions. For example, firms might differ according to culture, quality, location, etc. Potential partners can choose to match on only a few dimensions, and generate relatively low surplus, or they can choose to find a partner who matches on a large number of dimensions, and generate a great deal of surplus.

The intuition for the model’s key result is that firms trade off searching for increased synergies with the diminished bargaining power they may possess if they face a high quality partner. In equilibrium we show that firms continue to search for a partner until they find a match on many dimensions. Any firm would like a ‘better’ partner, ceteris paribus, and any match may have the potential to generate some surplus, but better partners have more bargaining power. Thus, lower quality firms choose to search for lower quality partners to get a larger fraction of smaller synergies. Because high quality firms can generate more surplus by pairing with other high quality firms, lower quality firms prefer to settle for lower quality partners than to wait for a higher quality partner but face a disadvantaged bargaining position. In equilibrium, this is reflected in their M/B ratios: the best type A firms (who endogenously have the highest M/B) merge with the best type B firms, and targets and acquirers have M/B ratios that come from similar deciles within their industries.

B. Search and Scarcity effects on Matching

Since the idea of complementarity is placed in the context of a search model the degree to which firms assortatively match depends on the search costs. Furthermore, the firms relative scarcity effects that absolute difference between the M/B of A and B firms. In this subsection we explore the effects of search and scarcity on the matching and relative M/B ratios of merging firms.

The following corollary gives a second important prediction.

Corollary 1  If the discount rate is low then assortative matching is more likely to hold and the difference in the rank of market-to-book ratios of merging firms will be smaller.

Proof. See appendix. ■
This prediction is striking precisely because both intuition and q-theory suggest the opposite. In low discount rate environments the M/B differential across firms is greater (as shown by Jovanovic and Rousseau, 2002) therefore, there is more opportunity for a high M/B firm to buy a low M/B firm. However, in Section V we provide empirical evidence that supports this prediction. Even though the M/B dispersion is lower in high discount rate times, the firms that merge have greater M/B differentials. This is because as search becomes more costly matching breaks down.

Harford (2003) finds that mergers that occur during waves create more value than non-wave mergers. Since Rhodes-Kropf, Robinson and Viswanathan (2005) show that waves occur when valuations are high there is more likely to be matching during waves. Thus mergers during waves should create more value because of the greater matching.

The effect of complementarity leads to one more prediction. As noted above, if firms choose to match on more dimensions, then the subset of firms with whom they can match is smaller. That is, if firms match on many criteria then $\rho$ becomes smaller as it becomes less likely that firms can find a partner with all of the correct dimensions.\footnote{Note that matching on more dimensions does not change the relative scarcity of the firms who merge. To provide intuition, imagine that there were 60 type A firms and 40 type B firms, then matching on a second characteristic would mean that there were 30 type A1 firms and 20 type B1 firms. Thus, a higher degree of matching does not change firms relative scarcity ($60/40 = 30/20$).} This affects the relative bargaining strengths of the merging firms.

**Corollary 2** *Increasing the degree of assortative matching causes firms to split the gains from merger more equally.*

**Proof.** See appendix \sidehead{Proof.}

Adding another dimension to consider in a merger match has two effects. First, if the new dimension is important for the creation of synergies then the matched mergers will increase in value. That is, $s_{A_kB_k}$ will be greater. Second, every dimension divides the subset of potential partners of each firm in half. This in turn reduces the probability of finding such a partner. Firms are endogenously making a trade-off. The naturally more scarce firm is giving up bargaining power conveyed by his relative scarcity in order to gain from increased profits. Simultaneously the less scarce firm is willing to keep searching precisely because the more scarce...
firm has reduced their relative bargaining power. If the more scarce firms bargaining power did
not endogenously decrease then the less scarce firm would take a merger with another partner!
Both firms must simultaneously choose to wait for the other in order to achieve assortative
matching. Thus targets and acquirers naturally tend to share the gains from merger as firms
choose to match along more dimensions.

The intuition is simple. If a match is rare then when it occurs neither side is willing to
walk away. The relative scarcity becomes less important as the absolute scarcity of both firms
dominates. Firms become ‘equally scarce’ because neither firm is likely to find as perfect a
match. Thus, the firms have equal bargaining power.

Overall, our theory is a “Birds of a Feather” theory of mergers that builds on the desire
of better firms to get together to endogenously deliver the remarkable similarity of M/B ratio
ranks that we see in the data. Our theory further predicts how this tightness should vary
through different discount rate environments and in mergers of equals vs unequals. We are
suggesting that the desire to match on different dimensions is an important driver in mergers
and acquisitions. The next section explores the empirical relevance of these predictions.

V  Re-examining the Empirical Evidence

In this section we return to the data and explore the empirical predictions of assortative
matching for merger activity. The first empirical prediction we explore is that bidders and
targets should be drawn from similar points in the distribution of M/B ratios. Put differently,
this prediction states that M/B ratios should be equal in a relative sense, rather than an
absolute sense. The second prediction is that the equality of market-to-book ratios should be
highest in high valuation regimes, since in these periods the returns to searching for better
matches increase.

A. Exploring the Relative Ranking Prediction

To explore the first prediction, we plot the bivariate distribution of M/B rankings for bidders
and targets. This allows us to explore the empirical validity of Proposition 4, which predicts
that the best firm from industry A should merge with the best firm from industry B even if the M/B across the two industries is very different. Since bidders and targets often come from different industries the theory tells us to rescale the market/book ratio before ranking them so that outliers from disparate industries are not mistakenly ranked close together (for example, a low valuation acquirer in a high-average-value industry could purchase a high valuation target in a low-average-valuation industry). To do this, we express the M/B ratio as a deviation from each firm’s industry median.

This bivariate distribution is presented in Figure 2. The two horizontal axes in Figure 2 are the acquirer (left) and target (right) market-to-book ratios, grouped into deciles. The vertical axis counts the number of transactions that took place between bidders and targets with that market-to-book pairing. Thus, ‘high buys low’ transactions cluster at the left side of the graph, and ‘low buys high’ transactions cluster at the right side of the graph.

Under the null hypothesis that there is no relation between bidder and target market-to-book ratio, we should expect to see a more or less uniform grid of values. On the other hand, an extreme form of the high buys low prediction would yield a graph that was peaked on the left edge, where bidder valuation is highest and target valuation is lowest.

According to our theory, the bulk of merger activity should lie along the main diagonal. And indeed it does. The bulk of activity involves either ‘high buying high’ or ‘low buying low’: this can be seen by noting that the graph is shaped like a saddle, with peaks at the ‘high, high’ decile and the ‘low, low’ decile. Relatively little activity occurs in the ‘high buys low’ or ‘low buys high’ tails of the distribution. Instead, the fact that the bulk of merger activity lies on the main diagonal indicates that ‘like buys like’ when mergers occur.

Thus, the ‘like buys like’ effect presented in Table 1, which motivated our investigation, is actually an artifact of a much stronger phenomenon: firms are merging with other firms with a very similar relative rank. Proposition 4 told us to look beyond absolute rank differentials and examine industry adjusted relative M/B ranks. The small absolute difference in M/B between targets and acquirors (see table 1) occurs because the M/B across industries is similar. Thus, relative rank matching is reflected in absolute differentials.\(^{19}\) Thus, the true phenomenon we

\(^{19}\)It is interesting to note that even when one industry is redeploying the assets of another firm in a Q theory sense
find is that those acquirors with high M/B ratios relative to their industry buy targets who also have high M/B ratios relative to their industry even though the acquiror does tend to have a slightly higher M/B than the target.

B. Exploring the Discount Rate Prediction

Our theory also makes a second important prediction. Since firms must search to find partners the tendency for bidder and target M/B ratios to converge should be strongest in high valuation periods, i.e., when discount rates and search costs are low. To explore this prediction, we break the data into high valuation and low valuation regimes and examine bidder/target M/B spreads in these different regimes. This is presented in Table 4.

Panel A of Table 4 groups the data according to whether the merger occurred in a period of high or low valuation for the target firm. We determine ‘high’ or ‘low’ valuation by whether the industry median M/B ratio was above or below its long-run average value. In column (1), it reports the overall M/B dispersion, which is slightly higher in high valuation periods (.89 vs. .82). Yet in these high valuation periods, when dispersions are higher, the spread in bidder/target M/B ratio is 1/10th of what it is in low valuation periods! This evidence supports the idea that assortative matching is higher in high valuation periods than in low periods.

Next we break the sample into high/low valuation periods for both bidder and target. The central test comes from comparing market/book differentials in (low, low) valuation periods with those in (high, high) periods. In (high, high) periods, the difference in bidder and target M/B ratios is statistically insignificant from zero. On the other hand, in the (low, low) period, bidders have statistically lower market/book ratios than targets.

Thus, in the high valuation, high M/B dispersion times the M/B differential between merging firms is smaller, as predicted by the model. This is an important validation of the model as this prediction is not obvious ex-ante and is highly consistent with the idea of search in mergers.

(so absolute M/B differential is large), the best firm in industry A may not buy the worst firm in industry B, but rather the best firm A may buy the best B and the worst firm A may buy the worst B (so relative ranks are similar). Thus, the matching we find does not preclude Q-theoretic reasons for merging.
C. Market Reactions

Ultimately, market reactions to merger announcements tell us about the difference between the expected value of a potential merger and the expected value of an actual, announced merger. In our model, this is simply the difference in the price before and after the merger divided by the price before the merger, \((\pi_i^M - \pi_i^{MP})/\pi_i^{MP}\). Intuitively, this quantity should be affected by the magnitude of expected synergies, the probability of creating them, and a firm’s ability to negotiate for the surplus.

Recent work by Song and Walkling (2000, 2005) supports these intuitive predictions. Song and Walkling (2000) find when an acquisition is announced, the target’s rival firms exhibit abnormal stock returns. They find that the magnitude of the return is systematically related to the rival’s probability of later becoming an acquisition target itself. Song and Walkling (2005) show that the returns to a bidder’s rivals vary monotonically with the bidders returns: bidders with large positive returns engender market reactions in rivals that are also positive, and bidders with large negative returns engender negative market reactions in rivals. These findings indicate that market reactions reflect the magnitude of expected synergies and the probability that they occur.

Scarcity, the firm’s ability to negotiate for the surplus, has an ambiguous affect on the market reaction. If a firm is relatively more scarce it will capture more of the surplus from the merger, but the market expects the firm to be more likely to find a partner. Thus, the reaction of the market may be larger or smaller depending on which effect dominates. If a firm is relatively less scarce the market expects they are unlikely to find a partner so the news of a merger would be surprising. However, a relatively less scarce firm will have weak negotiating powers and therefore also not extract much of the benefit.

This ambiguity is borne out by other empirical work. Servaes (1991) and Lang, Stulz and Walkling (1989) argue that mergers between a high M/B acquirer and a low M/B target should have the greatest market reaction because these are better mergers. They find some support for this idea but they also find many results that seem inconsistent with this idea. For example, Servaes (1991) finds that the acquirer’s Q has no affect on the target’s reaction. Lang et al (1989) find that the Q estimates from the year before the merger do not explain the
bidders gain, but when low Q buys low Q then the target gains are higher. Furthermore, many of the bidder and target reactions are shown to be unrelated to differences in M/B. We would argue that this is because there are many different types of mergers and no reason that the best mergers are the ones where the target is relatively less scarce. Of course, some mergers are redeploying assets to a better use and therefore some mergers where high buys low will have high synergies. Thus, we would not be surprised to find that some high buys low mergers have positive announcement effects.

Ultimately, our model is not general enough to truly explain what part of a merger is not expected by the market. For example, bidders may announce acquisitions programs, changing the market’s expectations and hence the bidder’s M/B. Furthermore, in our model average reactions will be positive. The negative reaction that has been documented for acquirer stock prices may arise from the possibility that the acquirer is overvalued. This possibility is outside the scope of this model but is developed fully in Rhodes-Kropf and Viswanathan (2004) and explored empirically in Rhodes-Kropf, Robinson and Viswanathan (2005). Jovanovic and Braguinsky (2004) and McCardle and Viswanathan (1994) argue that the market reaction is due to learning about the investment opportunities of the target and acquirer. Market reaction is really about the benefits of this merger relative to the other possible potential options. What is the probability of a merger? What is the value from a merger? What do we expect each firm to extract from the merger? Overall market reactions are an interesting but difficult place to look to understand why mergers are occurring or the value they are creating.

VI Conclusion

One of the key results of the property rights theory of the firm is that complementary assets should be under common control. This means that in the market for corporate control we should observe firms with complementary assets or technologies joining together, redrawing the boundaries of the firm in such a way that complementary assets are placed under the command of a single firm.

This paper develops a search model with matching and asset complementarity that ties the
property rights theory of the firm to new facts about who buys whom in merger transactions. While conventional wisdom suggests that high asset value firms buy low asset value firms, we show that a more appropriate interpretation is that firms with similar asset valuations purchase one another. That is, mergers exhibit assortative matching: instead of ‘high buys low,’ we see that ‘like buys like.’ We argue that this assortative matching is a direct result of asset complementarity and costly search.

In our theory the decision to merge balances the expected benefits of pairing with the current potential partner against the expected benefits of waiting and finding a more suitable partner. In the model, the identity of the bidder or target is determined by the fact that incomplete contracts require one party to oversee the joint assets of the newly merged firm. This party is one whose managerial talent is best suited to the merged resources of the new entity. On the other hand, the market-to-book ratios of the bidder and target are determined by the relative bargaining power of each party during the merger negotiation. A firm with relatively more scarce assets will, in general, command a larger fraction of the surplus from merger, since it will be able to effectively threaten to break off merger negotiations and find an outside offer of equal or greater value. Markets impound the expected value of this added surplus into market prices ex ante, which means that firms with relatively more scarce assets will have a higher market-to-book ratio, even if their investment opportunities are no different than their counterparty in the merger transaction.

When we add asset complementarity to the model, we find that firms with similar market-to-book ratios end up merging with one another. The assumption that merging firms have complementary assets arises from Hart and Moore (1990), Hart (1995) and the incomplete contracting literature. In our model, each firm trades off its desire to merge with a better partner with the endogenously reduced bargaining power they will have in such a merger. In equilibrium, if complementarity is important, successful mergers will exhibit a high degree of matching. The best targets and the best acquirers have the best outside opportunities and create the most synergies. They endogenously choose to search for each other. Therefore, in equilibrium firms who have the highest M/B ratios in their respective industries will choose to merge. Our point is that relative scarcity determines who gets more surplus from the merger
while complementarities cause the best to merge with the best.

The model predicts that the difference in M/B ratios should increase when discount rates are high and valuation levels are low. It also predicts that the relative rank of bidder and target M/B ratios is driven towards equality as a result of matching. When we revisit the data, we find that both these predictions hold.

There are a number of fruitful avenues for future work. Our model allows us to bridge the gap between the property rights theory of the firm and the empirical evidence on merger and acquisition activity. Our findings indicate that mergers reflect conscious efforts to redraw the boundaries of the firm in a manner that best allows complementary assets to be placed under common control. Developing new empirical tests of these predictions may shed better light on the motives for merger activity by more fully articulating the ways in which complementarities arise. For example, future work could explore the pattern of assortative matching over the business cycle or through merger waves.

Our work also has implications for how firms are sold. Boone and Mulherin (2004) document the fact that some firms solicit many merger offers while others negotiate with a single partner. This reflects some equilibrium in the search market in which perceived scarcity of assets and the potential desire to find optimal asset complementarities drive firms to solicit an optimal number of merger offers. Our model offers one way to think about the process by which firms go about searching for and identifying partners.

Furthermore, our empirical findings suggest that merger activity may be a rich area for examining the general theories and predictions from assortative matching models. The advantage of merger markets over more traditional applications of search theory, such as marriage markets, is that in merger activity the market values of the firms in question allow us to identify more cleanly matching parameters that may be difficult to observe in other settings.

Our analysis also complements theories of misvaluation, such as Rhodes-Kropf and Viswanathan (2004). In Rhodes-Kropf and Viswanathan, mergers occur for un-modelled fundamental reasons that are confounded or magnified by the possibility of misvaluation. Instead of focusing on why firms merge, their work focusses on when they occur and what transaction medium they use. This paper instead focus on the fundamental reason for mergers. Combining these
ideas could better explain why mergers cluster in time at the industry level (Mitchell and Mulherin, 1996; Harford, 2003; Rhodes-Kropf, Robinson, Viswanathan, 2005).

In addition, our main empirical finding—that like buys like—casts a new light on many questions in corporate finance. Do diversifying mergers exhibit stronger or weaker assortative matching? Do the long-run valuation consequences of mergers vary according to the degree of assortative matching that occurs? Are like-buys-like mergers more likely to shed unrelated assets around the time of the merger? Are like-buys-like transactions more likely to be initiated by better governed firms? Can these findings explain why some conglomerate firms trade at a discount relative to a portfolio of stand-alone firms? We leave each of these tasks for future research.
References


Proof of Proposition 1: We begin with Equations (6) and (14). These can be rearranged and written as

$$\pi_i^{MP} = c_1i(\Delta)\pi_i^M + c_2i(\Delta)\pi_i^{NM} + c_3i(\Delta), \quad (A1)$$

where

$$c_1i(\Delta) = \frac{\Delta q_i(\theta)\exp(-\Delta \lambda^{MP})\exp(-r\Delta)}{1 - (1 - \Delta q_i(\theta))\exp(-\Delta \lambda^{MP})\exp(-r\Delta)}, \quad (A2)$$

$$c_2i(\Delta) = \frac{(1 - \exp(-\Delta \lambda^{MP}))\exp(-r\Delta)}{1 - (1 - \Delta q_i(\theta))\exp(-\Delta \lambda^{MP})\exp(-r\Delta)},$$

$$c_3i(\Delta) = \frac{\Delta z_i (K_i^{NM*})^\alpha \exp(-r\Delta)}{1 - (1 - \Delta q_i(\theta))\exp(-\Delta \lambda^{MP})\exp(-r\Delta)}.$$ 

And

$$\pi_i^{NM} = c_{4i}(\Delta)\pi_i^M + c_{5i}(\Delta), \quad (A3)$$

where

$$c_{4i}(\Delta) = \frac{(1 - \exp(-\Delta \lambda^{NM}))\exp(-r\Delta)}{1 - \exp(-\Delta \lambda^{NM})\exp(-r\Delta)}, \quad (A4)$$

$$c_{5i}(\Delta) = \frac{\Delta z_i (K_i^{NM*})^\alpha \exp(-r\Delta)}{1 - \exp(-\Delta \lambda^{NM})\exp(-r\Delta)}.$$ 

Solving for $\pi_i^{MP}$ we find

$$\pi_i^{MP} = \frac{c_1i(\Delta)\pi_i^M + c_2i(\Delta)c_{5i}(\Delta) + c_3i(\Delta)}{1 - c_2i(\Delta)c_{4i}(\Delta)}. \quad (A5)$$

Using Lemma 1 and solving we find

$$\pi_i^{MP} = \frac{c_1i(\Delta)\frac{1}{2}s - c_1i(\Delta)\frac{1}{2}\pi_j^{MP} + c_2i(\Delta)c_{5i}(\Delta) + c_3i(\Delta)}{1 - c_2i(\Delta)c_{4i}(\Delta) - \frac{1}{2}c_1i(\Delta)}. \quad (A6)$$

Since this equation is true for both firm A and B we have two equations and two unknowns (throughout this paper $i \neq j$, $i, j \in \{A, B\}$). Taking the limit as $\Delta \to 0$ and using L’Hôpital’s rule we find

$$\lim_{\Delta \to 0} c_1i(\Delta) = \frac{q_i(\theta)}{\lambda^{MP} + r + q_i(\theta)}, \quad \lim_{\Delta \to 0} c_2i(\Delta) = \frac{\lambda^{MP}}{\lambda^{MP} + r + q_i(\theta)},$$

$$\lim_{\Delta \to 0} c_3i(\Delta) = \frac{z_i (K_i^{NM*})^\alpha}{\lambda^{NM} + r}, \quad \lim_{\Delta \to 0} c_{4i}(\Delta) = \frac{\lambda^{NM}}{\lambda^{NM} + r},$$

$$\lim_{\Delta \to 0} c_{5i}(\Delta) = \frac{z_i (K_i^{NM*})^\alpha}{\lambda^{NM} + r}.$$ 

Therefore, using the fact that if $x_n \to x$ and $y_n \to y$ then $x_ny_n \to xy$ we find that

$$\pi_i^{MP} = \frac{q_i(\theta)\frac{1}{2}s + \left(\frac{\lambda^{MP}}{\lambda^{NM} + r} + 1\right)z_i (K_i^{NM*})^\alpha - q_i(\theta)\frac{1}{2} \frac{q_i(\theta)\frac{1}{2}s + \left(\frac{\lambda^{MP}}{\lambda^{NM} + r} + 1\right)z_i (K_i^{NM*})^\alpha}{\lambda^{MP} + r + \frac{1}{2}q_i(\theta) - \lambda^{MP} \frac{\lambda^{NM}}{\lambda^{NM} + r} - q_i(\theta)\frac{1}{2} \frac{q_i(\theta)\frac{1}{2}s + \left(\frac{\lambda^{MP}}{\lambda^{NM} + r} + 1\right)z_i (K_i^{NM*})^\alpha}{\lambda^{MP} + r + \frac{1}{2}q_i(\theta) - \lambda^{MP} \frac{\lambda^{NM}}{\lambda^{NM} + r}}}}{\lambda^{MP} + r + \frac{1}{2}q_i(\theta) - \lambda^{MP} \frac{\lambda^{NM}}{\lambda^{NM} + r} - q_i(\theta)\frac{1}{2} \frac{q_i(\theta)\frac{1}{2}s + \left(\frac{\lambda^{MP}}{\lambda^{NM} + r} + 1\right)z_i (K_i^{NM*})^\alpha}{\lambda^{MP} + r + \frac{1}{2}q_i(\theta) - \lambda^{MP} \frac{\lambda^{NM}}{\lambda^{NM} + r}}}.$$ 

(A7)
Let $D = \lambda^{MP} - \lambda^{MP} \frac{\lambda^{NM}}{\lambda^{NM} + r}$ and remember that output $y_i = z_i \left( K_i^{NM*} \right)^{\alpha}$. Therefore, Equation (A7) can be reduced to

$$
\pi_i^{MP} = \frac{(2D + q_i(\theta)) Y_i + q_i(\theta) (s - Y_j)}{2D + q_i(\theta) + q_j(\theta)}.
(A8)
$$

Using lemma 1 we can substitute into the negotiation equilibrium, Equation (14), and solve for the merger profit

$$
\pi_i^M = \frac{(D + q_i(\theta)) (s - Y_j) + (D + q_j(\theta)) Y_i}{2D + q_i(\theta) + q_j(\theta)}.
(A9)
$$

Finally we can substitute into Equation (6)

$$
\pi_i^{NM} = \frac{\lambda^{NM}}{\lambda^{NM} + r} \frac{(2D + q_j(\theta)) Y_i + q_i(\theta) (s - Y_j)}{2D + q_i(\theta) + q_j(\theta)} + \frac{y_i}{\lambda^{NM} + r}.
(A10)
$$

We must also check that $\pi_i^{MP} < \pi_i^M$ because we assumed in the writing of Equation (14) that if a suitable partner is found a merger would occur. This reduces to checking that $0 < s - Y_j - Y_i$, which is true as long as the merger creates value.

Finally, it is easy to show that firms have no incentive to commit to a non-optimal level of capital since $\frac{d}{dt}(\pi_i^M - I_i) \leq 0$ reduces to $K_i \leq \alpha^{1/\alpha}$.

**Proof of Proposition 2:** First, recall that firm A’s scarcity is decreasing in $\theta$, while firm B’s scarcity is increasing in $\theta$. The derivative of each firm’s share with respect to $\theta$ is

$$
\frac{\partial \pi_A^M}{\partial \theta} = \frac{D (s - Y_B - Y_A) (q_A'(\theta) - q_B'(\theta))}{(2D + q_A(\theta) + q_B(\theta))^2},
(A11)
$$

$$
\frac{\partial \pi_B^M}{\partial \theta} = \frac{D (s - Y_A - Y_B) (q_B'(\theta) - q_A'(\theta))}{(2D + q_A(\theta) + q_B(\theta))^2}.
$$

We know $q_A'(\theta) < 0$ and $q_B'(\theta) > 0$, therefore, $\frac{\partial \pi_A^M}{\partial \theta} < 0$ and $\frac{\partial \pi_B^M}{\partial \theta} > 0$.

**Proof of Proposition 3:** Remember that firm A’s scarcity is increases if $\theta$ decreases and firm B’s scarcity increases if $\theta$ increases. The first part of the proposition is true because $q_A'(\theta) \leq 0$ and $q_B'(\theta) \geq 0$. The second part is shown in Proposition 2. And the last part is true if $\frac{\partial \pi_A^{NM}}{\partial \theta} < 0$, $\frac{\partial \pi_B^{NM}}{\partial \theta} < 0$, $\frac{\partial \pi_A^{MP}}{\partial \theta} > 0$, $\frac{\partial \pi_B^{MP}}{\partial \theta} > 0$, $\frac{\partial \pi_A^{MP}}{\partial \theta} > 0$, since capital in every state is unaffected by $\theta$.

$$
\frac{\partial \pi_A^{NM}}{\partial \theta} = \lambda^{NM} \frac{[2Dq_A'(\theta) + q_B(\theta)q_A'(\theta) - q_A(\theta)q'_B(\theta)] (s - Y_B - Y_A)}{(2D + q_A(\theta) + q_B(\theta))^2},
(A12)
$$

$$
\frac{\partial \pi_A^{MP}}{\partial \theta} = \frac{[2Dq_A'(\theta) + q_B(\theta)q_A'(\theta) - q_A(\theta)q'_B(\theta)] (s - Y_B - Y_A)}{(2D + q_A(\theta) + q_B(\theta))^2},
(A13)
$$

$$
\frac{\partial \pi_B^{NM}}{\partial \theta} = \frac{[Dq_B'(\theta) + q_B(\theta)q_B'(\theta) - q_B(\theta)q'_B(\theta)] (s - Y_B - Y_A)}{(2D + q_A(\theta) + q_B(\theta))^2},
(A14)
$$

where $D = r \frac{\lambda^{MP} + \lambda^{NM}}{\lambda^{NM} + r}$ and output $y_A = z_A \left( K_A^{NM*} \right)^{\alpha}$, $\frac{\partial \pi_A^{NM}}{\partial \theta} < 0$ and $\frac{\partial \pi_A^{MP}}{\partial \theta} < 0$ if

$$
[2Dq_A'(\theta) + q_B(\theta)q_A'(\theta) - q_A(\theta)q'_B(\theta)] < 0,
(A15)$$

40
and \( \frac{\partial z_i^M}{\partial \theta} < 0 \) if

\[
[Dq_i'(\theta) + q_B(\theta)q_j'(\theta) - Dq_j'(\theta) - q_A(\theta)q_B(\theta)] < 0.
\]

(A16)

Both are true since \( q_i'(\theta) \leq 0 \) and \( q_j'(\theta) \geq 0 \). The proofs for firm B are parallel and are omitted.

**Proof of Lemma 2:** Let \( i \neq j \), \( i, j \in \{A, B\} \) and \( h, k \) subscripts represent subtypes, \( h, k \in N \) and \( k \neq h \). We will conjecture that \( \pi_{ik}^{MP} < \pi_{ik}^{NM}(jk) \), which we will confirm in equilibrium. And, we will conjecture that \( \pi_{ik}^{M}(jk) < \pi_{ik}^{MP} \) \( \forall k \neq h \) and then we will look at what conditions will make this true in equilibrium. In this case, the profit when Mergers are Possible reduces to

\[
\pi_{ik}^{MP} = \left[ (\rho q_i(\theta) - \lambda^{NM} \pi_{ik}^{NM}(B_k) + (1 - \rho q_i(\theta) - \Delta^{NMP}) e^{-\lambda^{MMP}} + (1 - e^{-\lambda^{NMP}}) \pi_{ik}^{NM} + \Delta z_{ik} (K_{ik}^{NM})^\alpha \right] e^{-r\Delta}.
\]

(A17)

Following steps virtually identical to the proof of Proposition 1 results in the solution:

\[
\pi_{ik}^{NM} = \frac{\lambda^{NM}}{\lambda^{NM} + \rho} \left( \pi_{ik}^{MP} + rY_{ik} \right),
\]

(A18)

\[
\pi_{ik}^{MP} = \left( \frac{2D + \rho q_j(\theta)}{2D + \rho q_i(\theta) + \rho q_j(\theta)} \right) Y_{ik} + \rho q_i(\theta) (s_{ik}B_k - Y_{jk}),
\]

(A19)

\[
\pi_{ik}^{M}(jk) = \left( \frac{D + \rho q_i(\theta)}{2D + \rho q_i(\theta) + \rho q_j(\theta)} \right) Y_{ik} + (D + \rho q_j(\theta)) Y_{ik},
\]

(A20)

where \( D = \frac{\lambda^{MP} + \lambda^{NM} + \rho}{\lambda^{NM} + \rho} \) and output is \( y_{ik} = z_{ik} (K_{ik}^{NM})^\alpha \). It is now clear that \( \pi_{ik}^{MP} < \pi_{ik}^{M}(jk) \) as conjectured.

A subtype \( k \) firm has a disagreement utility of \( \pi_{ik}^{MP} \) and a type \( h \) firm has a disagreement utility of \( \pi_{ih}^{MP} \). The synergy between a subtype \( k \) and a subtype \( h \) firm would be \( s_{ik,jh} \). For two firms subtype \( k \neq h \) to be unwilling to consummate a deal it must be that \( \pi_{ik}^{M}(jk) < \pi_{ik}^{MP} \), or \( s_{ik,jh} - \pi_{ik}^{MP} < \pi_{ik}^{M}(jk) \). Thus, using the equilibrium disagreement utilities and the definition of the synergy we find different types will not merge with each other as long as

\[
2D [s_{ik,jh} - Y_{jh} - Y_{ik}] + \rho q_j(\theta) [s_{ik,jh} - s_{ih,jh}] < \rho q_i(\theta) [s_{ik,jh} - s_{ih,jh}].
\]

(A21)

Thus, if this condition holds then the only mergers will be between the same types. It might seem that a high number type firm that found a ‘bigger’ lower number type partner would always like to merge so that \( \pi_{ik}^{M}(B_1) > \pi_{ik}^{MP} \). This is not the case. Certainly a type 2 firm who finds a type 1 firm may generate more production than if they merge with a type 2 firm, but then the type 1 firm has more bargaining power. Thus, both firms may find it mutually beneficial to continue searching.\(^{20}\)

Simultaneously, for two firms subtype \( k = h \) to be willing to consummate a deal it must be that \( \pi_{ik}^{M}(jk) > \pi_{ik}^{MP} \), or \( s_{ik,jk} - \pi_{ik}^{MP} > \pi_{ik}^{M}(jk) \). Using the equilibrium disagreement utilities and the definition of the synergy we find that the same subtypes will merge with each other as long as

\[
2D [s_{ik,jk} - Y_{jk} - Y_{ik}] > 0.
\]

(A22)

\[^{20}\text{It may also seem that we must be concerned that even though } \pi_{A_2}^{M}(B_1) < \pi_{A_1}^{MP} \text{ that for the merger partner } \pi_{B_1}^{M}(A_2) > \pi_{B_1}^{MP}. \text{ However, any solution to the Nash bargaining solution must give both firms more than their reservation value so } \pi_{A_2}^{M}(B_1) < \pi_{A_1}^{MP} \text{ implies } \pi_{B_1}^{M}(A_2) < \pi_{B_1}^{MP}.\]
Which is true by the assumption that synergies are positive.

**Proof of Proposition 4:** Let \( i \neq j \), \( i,j \in \{A, B\} \) and \( h, k \) subscripts represent subtypes, \( h, k \in N \) and \( k \neq h \). The M/B ratio has two components: part that is due to the stand alone firm value and part that is from the potential gain from the merger. Remembering that \( K_{ik}^{NM*} = K_{ik}^{MP*} \), we can write the portion of M/B due to potential merger gains as \( (\pi_{ik}^{MP} - Y_{ik}) / K_{ik}^{NM*} \). If firms could not merge their M/B ratio would be

\[
Y_{ik} / K_{ik}^{NM*} = \frac{z_{ik}(K_{ik}^{NM*})^{\alpha-1}}{r} = \frac{1}{\alpha}. 
\]

Thus, with mergers, the total M/B ratio pre merger is

\[
\frac{\pi_{ik}^{MP}}{K_{ik}^{NM*}} = \frac{1}{\alpha} + \frac{\pi_{ik}^{MP} - Y_{ik}}{K_{ik}^{NM*}},
\]

in the Mergers are Possible state. And

\[
\frac{\pi_{ik}^{NM}}{K_{ik}^{NM*}} = \frac{\lambda_{NM}}{\lambda_{NM} + r} \left( \frac{\pi_{ik}^{MP} + rY_{ik}}{K_{ik}^{NM*}} \right),
\]

in the No Mergers state.

Lemma 2 ensures that If condition (20) holds then firms will assortatively match. So firms with the same subtype will merge, i.e., \( A_h \) will merge with \( B_k \). Given that condition (20) holds, Lemma 2 provides the equilibrium solution. Therefore, the M/B ratios can be rewritten

\[
\frac{\pi_{ik}^{MP}}{K_{ik}^{NM*}} = \frac{1}{\alpha} + \frac{\rho q_i(\theta) (s_{ik} - Y_{ik})}{[2D + \rho q_i(\theta) + \rho q_j(\theta)] K_{ik}^{NM*}},
\]

\[
\frac{\pi_{ik}^{NM}}{K_{ik}^{NM*}} = \frac{\lambda_{NM}}{\lambda_{NM} + r} \left( 1 + \frac{1}{\alpha} + \frac{\rho q_i(\theta) (s_{ik} - Y_{ik})}{[2D + \rho q_i(\theta) + \rho q_j(\theta)] K_{ik}^{NM*}} \right).
\]

Thus, our naming condition is such that firms with the lowest \( k \) have the highest M/B as long as \( (s_{ik} - Y_{ik}) / K_{ik}^{NM} \) is an increasing function of \( z_i \). This equation can be rewritten as

\[
\left( \frac{1}{\alpha} \right) \frac{1}{\alpha} (z_M)^{1-\alpha} - \left( \frac{z_{ik}}{z_{ik}} \right)^{1-\alpha} - \left( \frac{z_{jk}}{z_{ik}} \right)^{1-\alpha}.
\]

So the ex ante M/B is increasing in \( z_{ik} \) as long as

\[
\frac{d}{dz_{ik}} \left[ 2 \left( \frac{z_M}{z_{ik}} \right)^{1-\alpha} - \left( \frac{z_{jk}}{z_{ik}} \right)^{1-\alpha} \right] > 0.
\]

Which is clearly true for \( z_M = z_{ik} * z_{jk} \). Therefore, firms in the lowest ordinal subcategory have the highest M/B ratios pre merger. Therefore, the search for complementarities results in mergers in which type A firms with the largest M/B will merge with the type B firms with the largest M/B, while type A firms with the second largest M/B will merge with the type B firms with the second largest M/B, etc. Q.E.D.

**Proof of Corollary 1:** Let \( i \neq j \), \( i, j \in \{A, B\} \) and \( h, k \) subscripts represent subtypes, \( h, k \in N \) and \( k \neq h \). When Condition (20) holds, we need to show that raising the discount
rate makes it less likely to hold. This condition can be rewritten as

\[ s_{ikjh} - Y_{ik} - Y_{jh} < \frac{\rho q_i(\theta)}{2D + \rho q_i(\theta) + \rho q_j(\theta)} (s_{ikjh} - Y_{ik} - Y_{jh}) + \frac{\rho q_j(\theta)}{2D + \rho q_i(\theta) + \rho q_j(\theta)} (s_{ihjh} - Y_{i} - Y_{j}) \]

which can be further written as

\[
\frac{\rho q_i(\theta)}{2D + \rho q_i(\theta) + \rho q_j(\theta)} \frac{\frac{\alpha^{1-\alpha} - 1}{\alpha^{1-\alpha}}}{r^{1-\alpha}} \left( 2z_{ikjh}^{\frac{1}{\alpha}} - z_{ihjh}^{\frac{1}{\alpha}} - z_{jh}^{\frac{1}{\alpha}} \right) + \frac{\rho q_j(\theta)}{2D + \rho q_i(\theta) + \rho q_j(\theta)} \frac{\frac{\alpha^{1-\alpha} - 1}{\alpha^{1-\alpha}}}{r^{1-\alpha}} \left( 2z_{ihjh}^{\frac{1}{\alpha}} - z_{ihjh}^{\frac{1}{\alpha}} - z_{jh}^{\frac{1}{\alpha}} \right) > 0.
\]

Therefore we need to show that

\[
\frac{d}{dr} \frac{\rho q_i(\theta)}{2D + \rho q_i(\theta) + \rho q_j(\theta)} (s_{ikjh} - Y_{ik} - Y_{jh}) + \frac{d}{dr} \frac{\rho q_j(\theta)}{2D + \rho q_i(\theta) + \rho q_j(\theta)} (s_{ihjh} - Y_{i} - Y_{j}) - \frac{d}{dr} (s_{ikjh} - Y_{ik} - Y_{jh}) < 0.
\]

Or,

\[
\frac{\rho q_i(\theta)}{2D + \rho q_i(\theta) + \rho q_j(\theta)} \frac{\alpha^{1-\alpha} - 1}{\alpha^{1-\alpha}} \left( 2z_{ikjh}^{\frac{1}{\alpha}} - z_{ihjh}^{\frac{1}{\alpha}} - z_{jh}^{\frac{1}{\alpha}} \right) + \frac{\rho q_j(\theta)}{2D + \rho q_i(\theta) + \rho q_j(\theta)} \frac{\alpha^{1-\alpha} - 1}{\alpha^{1-\alpha}} \left( 2z_{ihjh}^{\frac{1}{\alpha}} - z_{ihjh}^{\frac{1}{\alpha}} - z_{jh}^{\frac{1}{\alpha}} \right) \\
> \frac{1}{1-\alpha} \left( \frac{\alpha^{1-\alpha} - 1}{\alpha^{1-\alpha}} \right) \left( 2z_{ikjh}^{\frac{1}{\alpha}} - z_{ihjh}^{\frac{1}{\alpha}} - z_{jh}^{\frac{1}{\alpha}} \right) (2D + \rho q_i(\theta) + \rho q_j(\theta)) \\
- \frac{2}{\alpha} D \frac{\alpha^{1-\alpha} - 1}{\alpha^{1-\alpha}} \left( 2z_{ikjh}^{\frac{1}{\alpha}} - z_{ihjh}^{\frac{1}{\alpha}} - z_{jh}^{\frac{1}{\alpha}} \right).
\]

Divide through by \( \frac{1}{1-\alpha} \frac{2D+\rho q_i(\theta)+\rho q_j(\theta)}{r} \) and this equation becomes the same as equation (A30) with an additional term subtracted from the RHS. Since since \( \frac{\partial}{\partial r} D > 0 \), the subtracted term reduces the RHS. Therefore, if there is assortative matching then equation (A30) holds. Thus raising \( r \) makes it harder for Condition (20) to hold. Q.E.D.

Proof of Corollary 2: If condition (20) holds then Lemma 2 tells us that firms match i.e. \( A_k \) merges with \( B_k \). The gains from a merger are \( s_{AhBh} - Y_{A_k} - Y_{B_k} \). Merger gains are being split more equally if \( \left( \left[ \pi^M_{A_k}(B_k) - Y_{A_k} \right] - \left[ \pi^M_{B_k}(A_k) - Y_{B_k} \right] \right) \) is smaller. Increasing \( d \) increases \( n \). Therefore, this lemma is true iff

\[
\frac{\partial}{\partial n} \left( \left[ \pi^M_{A_k}(B_k) - Y_{A_k} \right] - \left[ \pi^M_{B_k}(A_k) - Y_{B_k} \right] \right) > 0 \text{ if } \pi^M_{A_k}(B_k) - Y_{A_k} < \pi^M_{B_k}(A_k) - Y_{B_k}
\]
and
\[ \frac{\partial}{\partial n} \left[ (\pi^M_{A_k}(B_k) - Y_{A_k}) - (\pi^M_{B_k}(A_k) - Y_{B_k}) \right] < 0 \text{ if } \pi^M_{A_k}(B_k) - Y_{A_k} > \pi^M_{B_k}(A_k) - Y_{B_k}. \] (A32)

We know that
\[ \pi^M_{A_k}(B_k) - Y_{A_k} = \frac{(D + \rho q_A(\theta))(s_{A_k} B_k - Y_{B_k} - Y_{A_k})}{2D + \rho q_A(\theta) + \rho q_B(\theta)}. \] (A33)
\[ \pi^M_{B_k}(A_k) - Y_{B_k} = \frac{(D + \rho q_B(\theta))(s_{A_k} B_k - Y_{B_k} - Y_{A_k})}{2D + \rho q_A(\theta) + \rho q_B(\theta)}. \] (A34)

Therefore, \( \pi^M_{A_k}(B_k) - Y_{A_k} < \pi^M_{B_k}(A_k) - Y_{B_k} \) implies \( q_A(\theta) < q_B(\theta) \). We know \( \rho \equiv 1/n \).

Therefore,
\[ \frac{\partial}{\partial n} \left[ (\pi^M_{A_k}(B_k) - Y_{A_k}) - (\pi^M_{B_k}(A_k) - Y_{B_k}) \right] = \frac{\partial}{\partial n} \left( q_A(\theta) - q_B(\theta) \right) \frac{(s_{A_k} B_k - Y_{B_k} - Y_{A_k})}{2Dn + q_A(\theta) + q_B(\theta)} \]
\[ = \frac{[q_A(\theta) - q_B(\theta)]}{2Dn + q_A(\theta) + q_B(\theta)} \frac{\partial}{\partial n} (s_{A_k} B_k - Y_{B_k} - Y_{A_k}) - \frac{[(q_A(\theta) - q_B(\theta))(s_{A_k} B_k - Y_{B_k} - Y_{A_k})]}{[2D]} \]
\[ = \frac{(s_{A_k} B_k - Y_{B_k} - Y_{A_k})}{[2Dn + q_A(\theta) + q_B(\theta)]^2}. \] (A35)
\[ \text{which, since } \frac{\partial}{\partial n} (s_{A_k} B_k - Y_{B_k} - Y_{A_k}) > 0, \text{ is greater than } 0 \text{ if } q_A(\theta) < q_B(\theta) \text{ and less than } 0 \text{ if } q_A(\theta) > q_B(\theta). \] Q.E.D.
Figure 1: Distribution of M/B Spreads

This graph shows the distribution of the difference between the acquirer M/B ratio and the target M/B ratio. The area to the left of the origin on the x-axis is the 40% of the distribution for which the acquirer's M/B is lower than that of the target.
Figure 2: Industry-adjusted Ranking of Acquirer and Target M/B Ratios

This graph shows the bivariate distribution of M/B Ratios in mergers, but adjusts for the industry M/B of the bidder and target. The bottom axes, which run from 0 to 10, are M/B deciles for acquirers (on the left) and targets (on the right). “10” is the highest M/B; “0” is the lowest. The vertical axis is the count of the number of transactions with acquirer and target M/B ratios falling into that bin. A 1-st nearest neighbor smoothing approach is used to produce an empirical density. The fact that the peaks of the distribution occur at the 10/10 and 0/0 bins means that mergers are most commonly ‘high buying high’ and ‘low buying low’; the saddle down the 45-degree line in the x-y plane shows that most mergers involve ‘like buying like,’ regardless of their valuation level.
Expected profits in each state:

\( \Pi^{NM} = \text{No Mergers are beneficial} \)

\( \Pi^{MP} = \text{Mergers are Possible} \)
(beneficial if partner found)

\( \Pi^{M} = \text{Merger has occurred} \)

Figure 3: Extensive Form Representation of the Search Model
Table 1: Acquirer and Target M/B Ratios Using NYSE Deciles

<table>
<thead>
<tr>
<th>Target M/B Decile</th>
<th>NYSE M/B Decile of Acquirer</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Decile:</td>
<td>High 9 8 7 6 5 4 3 2 Low</td>
<td></td>
</tr>
<tr>
<td>High</td>
<td>252 95 49 39 26 20 21 8 9 24</td>
<td>543</td>
</tr>
<tr>
<td>9</td>
<td>102 79 44 36 23 16 9 2 7 13</td>
<td>331</td>
</tr>
<tr>
<td>8</td>
<td>100 51 49 54 25 13 12 12 7 14</td>
<td>337</td>
</tr>
<tr>
<td>7</td>
<td>78 76 58 42 30 30 11 9 7 8</td>
<td>349</td>
</tr>
<tr>
<td>6</td>
<td>55 41 34 56 45 25 19 23 5 6</td>
<td>309</td>
</tr>
<tr>
<td>5</td>
<td>47 35 37 45 62 51 26 16 12 15</td>
<td>346</td>
</tr>
<tr>
<td>4</td>
<td>28 30 36 43 53 49 39 30 13 13</td>
<td>334</td>
</tr>
<tr>
<td>3</td>
<td>22 26 28 32 41 42 35 24 21 15</td>
<td>286</td>
</tr>
<tr>
<td>2</td>
<td>12 26 20 22 42 33 24 24 21 18</td>
<td>242</td>
</tr>
<tr>
<td>Low</td>
<td>22 20 22 26 25 33 27 34 26 45</td>
<td>280</td>
</tr>
<tr>
<td>Total</td>
<td>718 479 377 395 372 312 223 182 128 171</td>
<td>3,357</td>
</tr>
</tbody>
</table>

Decile breakpoints are based on the distribution of m/b ratios for NYSE traded firms and were obtained from website of Professor Kenneth French (http://mba.tuck.dartmouth.edu/pages/faculty/ken.french). Each cell counts the number of mergers after 1980 between publicly traded bidders and targets in that decile pairing. The deciles are numbered from 10 to 1 in descending order of M/B.

Pearson’s $\chi^2$ test for independence of bidder and target m/b ratios has a value of 854.91, with an associated p-value of 0.00.

The mean acquirer lies in the fourth decile, while the mean target lies in the fifth decile of the m/b distribution. The mean difference is $\frac{8}{10}$ of a decile.
Table 2: Q Levels and Differences in Bidder and Target Q

<table>
<thead>
<tr>
<th>Scenario</th>
<th>Sample Size</th>
<th>Percent of Sample</th>
<th>Mean Scaled M/B Difference</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total Mergers, 1981-2001</td>
<td>3,400</td>
<td>100%</td>
<td>14.58</td>
</tr>
<tr>
<td>Mean Acquirer ln(M/B): .8118</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mean Target ln(M/B): .6816</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Target Exceeds Acquirer M/B</td>
<td>1,274</td>
<td>37%</td>
<td>-89.38</td>
</tr>
<tr>
<td>Acquirer Exceeds Target M/B</td>
<td>2,126</td>
<td>63%</td>
<td>77.16</td>
</tr>
<tr>
<td>Both Above Respective Industry Median</td>
<td>1,111</td>
<td>33%</td>
<td>11.46</td>
</tr>
<tr>
<td>Both Below Respective Industry Median</td>
<td>990</td>
<td>29%</td>
<td>2.38</td>
</tr>
<tr>
<td>Target Above, Acquirer Below</td>
<td>419</td>
<td>12%</td>
<td>-138.08</td>
</tr>
<tr>
<td>Acquirer Above, Target Below</td>
<td>880</td>
<td>26%</td>
<td>105.7</td>
</tr>
</tbody>
</table>

Scaled M/B Difference is the difference between acquirer ln(mb) and target ln(mb) divided by the standard deviation of the m/b for the acquirer’s industry in the year of the acquisition. The units are in percent of a standard deviation; i.e., 100 is one standard deviation.
Table 3: Time-Series of M/B Spreads

<table>
<thead>
<tr>
<th>Year</th>
<th>Count</th>
<th>Target</th>
<th>Acquirer</th>
<th>Median(T)</th>
<th>Median(A)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1981</td>
<td>37</td>
<td>0.22</td>
<td>0.43</td>
<td>0.21</td>
<td>0.12</td>
</tr>
<tr>
<td>1982</td>
<td>39</td>
<td>0.39</td>
<td>0.15</td>
<td>0.43</td>
<td>0.40</td>
</tr>
<tr>
<td>1983</td>
<td>52</td>
<td>0.27</td>
<td>0.31</td>
<td>0.51</td>
<td>0.41</td>
</tr>
<tr>
<td>1984</td>
<td>90</td>
<td>0.47</td>
<td>0.40</td>
<td>0.44</td>
<td>0.38</td>
</tr>
<tr>
<td>1985</td>
<td>104</td>
<td>0.49</td>
<td>0.46</td>
<td>0.64</td>
<td>0.64</td>
</tr>
<tr>
<td>1986</td>
<td>97</td>
<td>0.43</td>
<td>0.62</td>
<td>0.69</td>
<td>0.65</td>
</tr>
<tr>
<td>1987</td>
<td>126</td>
<td>0.70</td>
<td>0.68</td>
<td>0.52</td>
<td>0.53</td>
</tr>
<tr>
<td>1988</td>
<td>113</td>
<td>0.65</td>
<td>0.73</td>
<td>0.57</td>
<td>0.58</td>
</tr>
<tr>
<td>1989</td>
<td>110</td>
<td>0.61</td>
<td>0.62</td>
<td>0.56</td>
<td>0.55</td>
</tr>
<tr>
<td>1990</td>
<td>76</td>
<td>0.52</td>
<td>0.57</td>
<td>0.41</td>
<td>0.41</td>
</tr>
<tr>
<td>1991</td>
<td>89</td>
<td>0.48</td>
<td>0.71</td>
<td>0.65</td>
<td>0.62</td>
</tr>
<tr>
<td>1992</td>
<td>62</td>
<td>0.53</td>
<td>0.62</td>
<td>0.74</td>
<td>0.72</td>
</tr>
<tr>
<td>1993</td>
<td>97</td>
<td>0.71</td>
<td>0.97</td>
<td>0.77</td>
<td>0.76</td>
</tr>
<tr>
<td>1994</td>
<td>178</td>
<td>0.69</td>
<td>0.78</td>
<td>0.71</td>
<td>0.71</td>
</tr>
<tr>
<td>1995</td>
<td>239</td>
<td>0.67</td>
<td>0.84</td>
<td>0.83</td>
<td>0.84</td>
</tr>
<tr>
<td>1996</td>
<td>260</td>
<td>0.59</td>
<td>0.95</td>
<td>0.81</td>
<td>0.77</td>
</tr>
<tr>
<td>1997</td>
<td>358</td>
<td>0.72</td>
<td>0.86</td>
<td>0.99</td>
<td>0.97</td>
</tr>
<tr>
<td>1998</td>
<td>347</td>
<td>0.91</td>
<td>1.13</td>
<td>0.77</td>
<td>0.74</td>
</tr>
<tr>
<td>1999</td>
<td>365</td>
<td>0.82</td>
<td>1.12</td>
<td>0.87</td>
<td>0.86</td>
</tr>
<tr>
<td>2000</td>
<td>352</td>
<td>0.88</td>
<td>0.97</td>
<td>0.55</td>
<td>0.54</td>
</tr>
<tr>
<td>2001</td>
<td>208</td>
<td>0.71</td>
<td>0.83</td>
<td>0.50</td>
<td>0.44</td>
</tr>
</tbody>
</table>

This table reports average ln(M/B) for all targets and acquirers in a given year. Count is the number of transactions. Columns headed ‘Target,’ and ‘Acquirer,’ are, respectively, annual average ln(M/B) values for targets and acquirers involved in transactions that year. Columns headed ‘Median(T)’ and ‘Median(A)’ report the average value of the industry median ln(M/B) for the target and acquirer, respectively.
Table 4: Market/Book Differentials in High and Low Valuation Periods

Panel A: Target Industry Valuation Levels

<table>
<thead>
<tr>
<th></th>
<th>(1)</th>
<th>(2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Years When M/B Above Industry Median</td>
<td>.8922</td>
<td>.0115</td>
</tr>
<tr>
<td>Years When Below Industry Median</td>
<td>.817</td>
<td>.0965</td>
</tr>
</tbody>
</table>

Panel B: Valuation Levels for Target and Acquirer Industries

<table>
<thead>
<tr>
<th></th>
<th>Target Industry:</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Low</td>
<td>High</td>
<td></td>
</tr>
<tr>
<td>Acquirer Industry Low</td>
<td>-.090</td>
<td>-.251</td>
<td></td>
</tr>
<tr>
<td></td>
<td>.04</td>
<td>.11</td>
<td></td>
</tr>
<tr>
<td></td>
<td>1239</td>
<td>153</td>
<td></td>
</tr>
<tr>
<td>Acquirer Industry High</td>
<td>.054</td>
<td>.006</td>
<td></td>
</tr>
<tr>
<td></td>
<td>.07</td>
<td>.029</td>
<td></td>
</tr>
<tr>
<td></td>
<td>206</td>
<td>1471</td>
<td></td>
</tr>
</tbody>
</table>

In Panel A, Column (1) reports the overall industry dispersion in ln(M/B) ratios, expressed in standard deviations. Column (2) reports the median ln(M/B) spread between bidders and targets. In Panel B, targets and acquirers are in high/low valuation periods according to whether their industry is above/below its median ln(M/B) ratio. The top cell value is the average difference in ln(M/B) between bidder and target, weighted by transaction value. The middle number is the standard error, and the third number is number of transactions in the relevant valuation period.