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The Effect of Mergers and Acquisitions on Shareholder Value

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ABSTRACT:

Yrity maailmassa yrityskauppojen ja fuusioiden merkitys on kasvanut merkittävästi viimeisten vuosikymmenten aikana. Niiden vaikutuksen ymmärtäminen osakkeenomistajien arvoon on kriittinen sekä haastava tutkimuskysymys. Yrityskaupat ja fuusiot ovat merkittäviä, mutta myös riskialttiita strategioita. Onnistuessaan, ne voivat vahvistaa yrityksen asemaa markkinoilla, tuoda nopeaa kasvua sekä paljon hyötyä omistajille. Epäonnistumisen seuraukset voivat olla suuria ja aiheuttaa odottamattomia tappioita.

Tässä työssä pohditaan, millä perusteilla ja millaisissa tilanteissa yrityskaupat ja fuusiot voivat kasvattaa osakkeenomistajien varallisuutta ja milloin taas käy päinvastoin. Tekstissä yhdistyvät muun muassa taloustieteen teoriat ja käyttäytymistieteelliset näkökulmat. Lisäksi pohditaan, miten markkinatilanne, rahoitusjärjestelyt sekä maksutapa voivat vaikuttaa lopputulokseen. Eräs hyvä esimerkki on Facebookin ja Instagramin välinen yrityskauppa, jossa alussa markkinat suhtautuivat epäillen, mutta oikean strategian sekä onnistuneen päätöksenteon ansiosta kyseinen yrityskauppa toi yllättävän suuren arvon nousun. Yrityskaupoissa ja fuusioissa on tärkeää olla selkeä strategia sekä myös kyky hallita sijoittajien odotuksia.

KEYWORDS: Synergy, Abnormal return, Initial public offering (IPO), equity offerings, all-cash bids, cumulative abnormal return (CAR), Bidder and target, post-merger integration (PMI)

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1 Introduction

Mergers and acquisition (M&A) are business deals in which firms either combine into a single organization or one firm purchase another, resulting in a shift of control and ownership (Betton et al., 2008). M&A remain an important corporate strategy for firms to grow, diversify and strengthen their market position (Alexandridis et al., 2017). One critical aspect of M&A is how these deals influence shareholder value. This thesis aims to analyse the effects of M&A on shareholder value, focusing on whether M&A transactions create or destroy value for investors. By analysing existing research and financial data, this thesis' goal is to seek to determine the short-term and long-term influences of M&A on financial performance and share prices. A central case study will be the acquisition of Instagram by Facebook, a highly considered successful merger in the tech industry.

The primary goal of M&A deals is to create value for shareholders by expanding market share, achieving mutual benefits and enhancing efficiency (Devos et al., 2009). However, studies show different results on the impact of M&A on shareholder value. While shareholders of the target company usually benefit from the premium prices, which is paid by the acquirer, the effects on shareholders of the acquiring firm remain uncertain (Andrade et al., 2001).

This subject is important because M&A deals are common in modern business, and investors need to know whether these deals make good financial sense. Moreover, M&A plays a crucial role in shaping corporate strategy and can have significant influence on firm's success and long-term sustainability (Morosoni et al., 1998). Since shareholder value is widely considered as a key measure of corporate performance, understanding how mergers and acquisitions effects this measure offers valuable insights into strategic decision-making, market reactions and overall business growth (Alexandridis et al., 2017).

1.1 Purpose of the study

The purpose of this thesis is to examine how do M&A effect shareholder value for both acquiring and target firm. The thesis begins by investigating whether M&A announcements lead to systematic price effects and determines whether the shareholder of the target company or those of the acquiring company are affected. This leads to first hypotheses:

H1: Shareholders of target firm often benefit through positive abnormal returns, while the shareholders of the acquiring firm usually experience neutral or even negative short-time results.

Second, I study whether the payment method shapes market reactions and the likelihood of success. Cash offers can signal confidence and discipline, whereas stock payments can raise uncertainty unless they are well justified. This leads to second hypotheses:

H2: Markets tend to react more positively to cash financed deals than to those financed with stock.

Third, if value changes occur around the time of the M&A deals, I study what determines whether a merger creates or destroys the value. If governance discipline, strong enough strategic fit and above all, well-managed post-merger integration is present, the value should be created. Without these factors, deals are more likely to destroy value. This leads to third hypotheses:

H3: The way post-merger integration is managed, significantly effects on determining whether acquisitions create or destroy value.

1.2 Structure of the study

This thesis begins with an introduction that sets motivation and hypotheses. Chapter two develops the theory base by discussing agency theory and the tension between managerial motives and shareholder interest. Next central ideas in behavioural finance and their effect on M&A are discussed and how market efficiency matter for M&A. Moreover, the second chapter also covers where synergies come from, how value is captured, choices around financing and payment and what happens during post-merger integration. Chapter three focuses on institutional aspects and presents short case studies, especially Facebook-Instagram acquisition is presented in more detail. Chapter four reviews evidence on returns for acquirers and targets. Finally, chapter five concludes the findings of the study.

2 Theory

Mergers and acquisitions are among the most impactful and complicated strategic decisions a firm can make. They have attracted comprehensive academic research in numerous fields within economics and finance. Understanding their effect on shareholder value demands broad theoretical perspective. Classical financial theory, especially the Efficient Market Hypothesis (EMH) indicates that stock prices fully reflect all accessible public information, implying that M&A announcements need to be accurately and quickly incorporated into market valuations (Fama, 1970). From this perspective, any value gained or lost by a merger should be instantly visible in the market reaction.

However, this assumption is challenged by behavioural finance literature. Shleifer and Vishny (2003) argue that acquisitions are frequently driven by market mispricing, where companies with overvalued stock leverage their inflated share value as "cheap currency" to acquire undervalued targets. Bikhchandani et al. (1992) also point out that investor biases, for example overconfidence and herd behaviour may distort market reactions to corporate events. Herding refers to the tendency of people to follow the actions of a larger group rather than relying on their own critical thinking. This behaviour may lead to incorrect valuations at the time of the M&A announcements (Bikhchandani et al., 1992).

Moreover, agency theory offers another critical perspective by analysing the conflicts of interest between corporate managers and shareholders. Jensen and Meckling (1976) emphasize in their article that managers may engage in acquisitions not to maximize shareholder wealth, but to increase their personal interests, like earnings, power or even job security. They explain that this behaviour tends to be more significant when there is separation between control and ownership, resulting in agency costs that could interfere the proper allocation of financial assets.

These theoretical insights form the foundation for understanding how M&A may result in gains or losses for shareholder values, depending on the dynamics managerial interest, investor behaviour and market efficiency.

2.1 Agency theory

Agency theory is highly relevant for understanding why some M&A deals might fail to create or even destroy shareholder value. Agency theory explores potential conflicts which emerge when shareholders depend on corporate managers to make decisions on their behalf (Jensen & Meckling, 1976). According to Jensen and Meckling (1976) since managers have their own goals and risk preferences, they might not always act in the best interest of shareholders, unless their incentives are properly aligned. Incentives refer to rewards or motivations, such as promotion, bonuses or stock options that encourage managers to align their actions with shareholder interest. In a corporate setting, this conflict usually occurs when managers prioritize their personal interest, like higher pay, reduced employment risk, greater status rather than maximizing shareholder value (Jensen & Meckling, 1976). They point out that these conflicts can be worsened during M&A, where large sums of corporate resources and significant strategic choices are at stake.

Agency costs are the costs generated to ensure that managers (agents) act in the interest of shareholders, along with the value lost if alignments fail (Jensen, 1986). In the realm of M&A, agency costs can arise through several ways. Jensen (1986) describes that empire-building and overinvestment happen when managers prioritise expanding the company's size and their personal power instead of optimizing shareholder profits. Moreover, the author highlights another problem called managerial entrenchment. This happens when managers become so powerful within a firm that it's hard for anybody to challenge them or remove them from their roles. Sometimes, managers might even buy other firms only to stop takeover attempts and secure their own jobs (Jensen, 1986). Jensen

(1986) notes that the bad thing is that these acquisitions don't make always financial sense and can lower returns for the firm.

Furthermore, information asymmetry arises when managers typically possess greater knowledge about strategic aims and internal operations than shareholders, allowing them to justify acquisitions that might not be profitable (Jensen, 1986). Jensen (1986) also adds that inadequate governance structures, such as poorly designed compensation systems or ineffective boards of directors, fail to control self-serving managerial actions, leading to value-destroying deals.

2.1.1 Shareholder interests vs. Managerial motives

Managers might act against shareholder interest in M&A deals due to some strategic and behavioural factors (Jensen, 1986). For example, Jensen and Meckling (1976) explain that executives might be driven to the completion of M&A transactions instead of focusing on their actual performance or success. Amihud and Lev (1981) bring another point that seeking larger acquisitions can reduce firm's takeovers, thereby enhancing managerial job stability.

Additionally, some managers might be so overconfident that they believe they can succeed where others have failed, causing overpayment for target firms (Roll, 1986). This dynamic intersects with both agency theory and behavioural finance, which heightens the risk for shareholders. As Roll (1986) explains, managers with overconfidence may end up paying too many premiums for acquisitions, practically transferring wealth from the acquirer's shareholders to the target's shareholder. Regarding this topic, Jensen and Meckling (1976) argue that certain deals are affected more by managerial ambition than by clear synergy opportunities. Synergies in business mean the extra benefits a firm gets when it joins with another company, such as increased revenue, cost savings, or improved efficiency (Li, 2016). The idea is that merged firm will be more valuable than the two firms were separately, but sometimes, achieving these benefits can be challenging.

Jensen and Meckling (1976) note in their article that agency theory indicates that conflicts between managers and shareholders require strong control mechanism. Investors can play a crucial role by pressuring management to adjust or even block transactions that appear to be contrary to shareholder value (Amihud & Lev, 1981). Jensen and Meckling (1976) suggest that honest and clear communication between managers and shareholder about expected synergies helps reduce information gap and strengthen trust. Figure 1 shows the core idea of the agency problem.

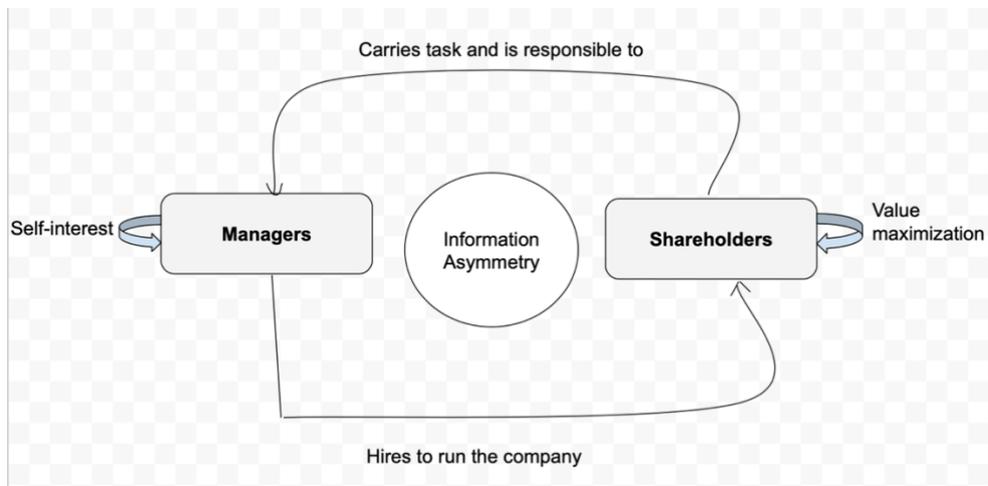


Figure 1. Agency problem.

2.2 Behavioural finance insights

Traditional finance theories assume that market participants behave rationally, and that business decisions are guided by maximizing shareholder value based on objective assessments (Tversky & Kahneman, 1974). Whereas behavioural finance shows that emotions, social influences and biases have a significant effect (Tversky & Kahneman, 1974). They argue that investor behaviour isn't always rational and can be affected more by psychological forces instead of fundamental data. According to Tversky and Kahneman (1974) both managerial decisions and investor reactions are shaped by behavioural impacts.

For instance, managers may initiate mergers based on overconfidence rather than economic reasoning. This idea is supported by Malmendier and Tate (2008), who note that overconfident CEOs have a higher tendency to engage in value-destroying acquisitions. Understanding these influences makes clear why some M&A deals fail to create shareholder value, even when they appear to be financially justifiable. Malmendier and Tate (2008) indicate that extreme self-enhancement and confidence among senior executives may lead to overpayment in acquisitions, which ultimately reduces company value.

2.2.1 Managerial biases and overconfidence

Overconfident CEOs usually believe they possess superior abilities to value, identify and integrate target companies (Roll, 1986). This overconfidence can lead to too much for a company, underestimating the difficulties of integration, or overestimating potential benefits of synergies. Roll's (1986) Hubris Hypothesis is central to this discussion. It suggests that managers, particularly executives of acquiring companies, tend to overpay for acquisitions because they are overly confident in their ability to create value afterward. Consequently, while target's shareholders may gain from higher offer prices, the acquirer's shareholders frequently experience value loss when synergy realizations fail to meet unrealistic hopes (Roll, 1986).

Certain mental biases sometimes result in poor decisions in M&A transactions. One such bias is "anchoring", where decision-makers may rely too much on past previous valuations, initial offers or deal prices when deciding the price of a target, which can cause biased valuations (Tversky & Kahneman, 1974). Another bias is confirmation bias, which says that once managers trust a deal is important, they focus on evidence that supports it and ignore conflicting information (Doukas & Petmezas, 2007). Doukas and Petmezas (2007) add that another phenomenon seen in M&A transactions is M&A waves and herding which explains that acquisitions tend to happen in waves, driven by market trends and the actions of competitors. They highlight that if one firm makes a big acquisition, others may follow to stay competitive.

2.2.2 Investor psychology and behavioural risks

Beyond managerial biases, market sentiment plays an important role in how M&A announcements are viewed by investors and shareholders. When investor sentiment is high, like in bull market, they might push up the acquirer's stock price, expecting the deal to drive future growth (Dong et al., 2006). Dong et al. (2006) note that over time, however, as integration challenges become evident and synergy expectations are revised, the market may correct itself. According to them investor over-optimism and misvaluation can raise the value of the acquirer's shares, giving the impression that even weakly justified transaction is beneficial. They also add that these kinds of acquisitions often destroy shareholder value over time. One way to minimize behavioural biases in M&A deals is through strong corporate governance (Masulis et al., 2007). Active shareholders and independent boards can challenge overconfident managers and ensure careful deal evaluation (Masulis et al., 2007).

2.2.3 Herding behaviour

Herding behaviour refers to scenarios in which investors follow the actions of others rather than making decisions based on their own critical thinking, analysis and information (Bikhchandani et al., 1992). According to Bikhchandani et al. (1992), investors may assume that others have better information, and therefore they copy their actions. This can cause a large group of investors making the same decision at the same time, even if those decisions aren't based on facts. In financial markets, herding behaviour usually occurs around important events such as M&A. This pattern can lead to so-called "informational cascades", where early decisions effect the choices of others (Bikhchandani et al., 1992). Bikhchandani et al. (1992) present an example that if some investors start purchase firm's stock following a merger announcement, others might jump in too, believing that first group knows some valuable information, even if the merger's true value is yet unclear.

Devenow and Welch (1996) highlight in their article that herding behaviour is usual within institutional investor circles, like analysts or fund managers. They continue explaining that at times investors follow the crowd to protect their reputation. Investors may think that if everybody else is also in the wrong, individual mistakes are less noticeable. For M&A transactions, this may lead to unjustified overvaluation and optimism of the acquiring company, particularly during times of intense market activity. Herding behaviour also challenges the assumptions of Efficient Market Hypothesis because social and psychological factors can strongly impact how investors react to M&A which may affect shareholder value in a way that classical financial theory can't entirely explain.

2.3 The role of Efficient Market Hypothesis in M&A

To understand how behavioural patterns differ from traditional financial theory, it's important to examine the Efficient Market Hypothesis (EMH), which has long been the basis of classical thinking on investor rationality and price formation. First introduced by Fama (1970), EMH declares that stock prices immediately react to all new available publicly information. Fama (1970) explains when a merger is announced, the stock prices of firms involved should adjust to reflect the expected benefits, future earnings and costs. The core idea of EMH is that stock prices fully reflect all available information, therefore investors cannot repeatedly earn returns above the market average after taking risk into account (Fama, 1970).

Fama (1970) categorizes market efficiency into three different forms: weak, semi-strong and strong. The weak form claims that current stock prices fully reflect all past trading data, for example, volumes and prices. This implies that patterns or price trends cannot be used to anticipate future returns (Fama, 1970). Fama (1970) notes that in such markets, prices behave unpredictably, following a random walk, making technical analysis ineffective. The semi-strong form, which is especially relevant in the context of M&A, asserts that all publicly available information, financial reports and news reports, is immediately reflected in stock prices (Fama 1970). Fama (1970) claims that after

information is made public neither fundamental nor technical analysis can reliably produce returns above the market average. Lastly, the strong form of market efficiency states that stock prices reflect all information, including insider and private content (Fama, 1970). This would mean that not even those with privileged access to firm information can earn excess returns. However, as noted by Jensen (1986), this level of efficiency is uncommon in reality because of uneven access to information and regulatory. This phenomenon is summarized visually in Figure 2.

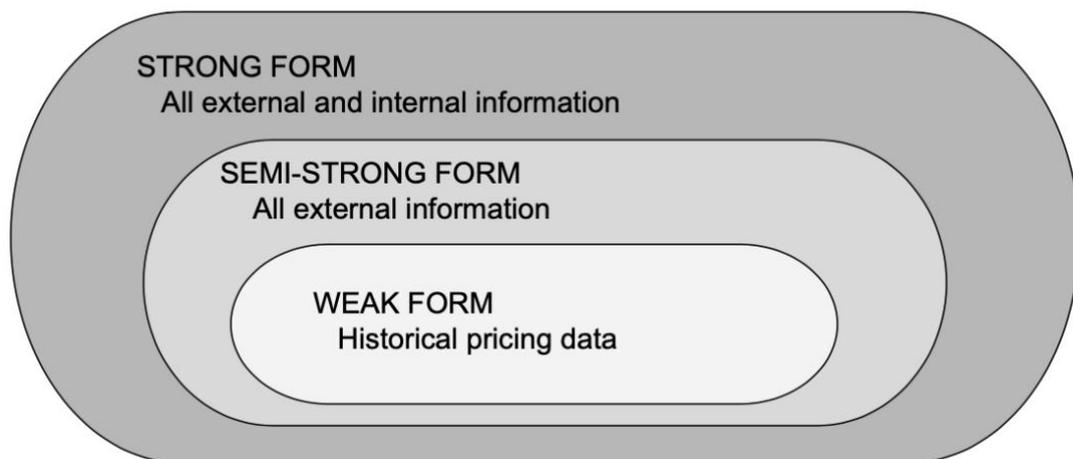


Figure 2. Efficient Market Hypothesis.

Within the semi-strong form of the EMH, it's assumed that stock prices adjust quickly to the public release of new information, including announcements of mergers (Fama, 1970). According to this structure, any unusual price changes near the announcement date reflect the market's logical evaluation of the deal's worth, including expectations regarding strategic fit, the costs of merging and potential benefits. Previous studies have repeatedly shown that shareholders of target companies tend to experience positive abnormal returns after the public release of M&A news (Andrade et al., 2001). As Andrade et al. (2001) mention in their article, these findings support the view that markets respond efficiently to new information, aligning with the semi-strong form of market efficiency.

In contrast, results concerning the firms making the acquisition is more mixed. Several studies have pointed out that acquirers, particularly large firms, often experience zero or even negative returns following merger announcements (Moeller et al., 2005). While such findings don't essentially disagree with the EMH, they raise important questions regarding whether the market fully reflects all publicly value-relevant, available information. Possible explanations include challenges related to integration, managerial overconfidence or value difficulties. These elements may not be fully clear to investors when the announcement is made.

2.4 Synergy behind M&A

Synergy is described as the most common strategic rationale behind M&A. The core idea is that the combined firm will be more valuable than the individual firms on their own - expressed simply as $1 + 1 > 2$ (Li, 2016). In practice this means, that through integration, firms seek to gain advantages such as increased revenue potential, cost reduction or improved operational efficiency that would be difficult or in most cases impossible to realise independently (Li, 2016).

Studies show that a significant portion of the extra amount paid in takeovers comes from the buyer's synergy expectations (Li, 2016). Li (2016) explains that this additional payment over the target's market value is known as the takeover premium, which reflects the buyer's belief in the value those synergies will create. For an European sample, Laamanen (2007) finds that about one-third of the 40-50 % acquisition premium paid for publicly listed targets can be explained by "strategic synergies". In the United States, the value of operating and financial synergies is estimated to be worth 10 % of the combined pre-deal equity, representing close to one-third of the usual premium paid in a bid (Devos et al., 2009). A French study shows a similar pattern, indicating that realised synergy gains approximately 12 % of the merged firm's value, with cost efficiencies accounting most of these benefits (Hamza et al., 2016).

Across these research, cost-related synergies frequently emerge as the most recognized advantage. Laamanen (2007) shows that these savings mainly result from combining overlapping roles, removing redundancies and leveraging economies of scale. Revenue synergies also play a crucial role. In their article, Devos et al. (2009) emphasize activities such as new customer segments, speeding up geographic expansion and cross-selling as essential contributors. A later French panel study by Hamza et al. (2016) supports these conclusions, observing that majority of financial synergies realized after a merger - referred to as post-merger gains - are primarily driven by cost efficiencies. While revenue enhancements do occur, their overall contribution to the total value creation tends to be relatively limited (Hamza et al.,2016). Since the combined influence of these efficiencies can be significant, many firms view M&A as a strategic path to growth. However, as King et al. (2004) warn, it's important to assess synergies with a realistically and implement them efficiently so they truly create value for shareholders.

2.4.1 Who captures the value?

Jensen (1986) reports that initial findings from U.S. takeover contests suggests that the distribution of benefits is markedly one sided: average announcement-day abnormal returns are around 30 % in tender offers, where bids go directly to shareholders, compared around 20 % in the case of negotiated mergers. Jensen (1986) attributes the higher premium in tender offers because of bidder's weaker negotiation position. By going directly to shareholders and bypassing target management, the acquirer needs to offer a high enough price to immediately gain majority support, which means giving up more of the expected synergies (Jensen, 1986).

A stream of studies has arrived at the same qualitative conclusion for bidders. A meta-analysis encompassing more than 37 000 individual observations finds that shareholders of acquiring company experience no significant financial gain from acquisitions once publication bias is considered (King et al., 2004). According to King et al. (2004), the research indicates that cumulative abnormal return (CAR) - which measure the difference between the actual stock return and what would normally be expected over

a period - are essentially equal to zero, and in fact tend to be a bit negative. This finding remains frequently strong across different research approach, time frames and industries, suggesting that any gains often go to the target companies via the premium paid in the offer (King et al.,2004).

Why do bidders receive such a small portion of the overall gains? One explanation is that many large transactions usually occur in quasi-auction environments, creating competitive pressure that raises the price (Betton et al., 2008, pp. 321-323). Quasi-auction means situations where, even if there is just one official bidder, other potential bidders are expected to be watching or preparing to bid. While M&A transactions are often motivated by synergy expectations, previous study (Moeller et al., 2005) indicate that acquirers may not fully realize the value created, specifically in large transactions - a topic that will be discussed in more detail later in this paper.

2.4.2 If acquirers rarely gain, why merge at all?

Although the average returns for acquirers may appear disappointing, they mask cases of significant outperformance. As noted by Tunyi (2021), in cases where the acquisitions come as a genuine surprise, marked by no market rumours or advance indication, shareholders of the acquiring firm experience abnormal returns of 5-7 % within the seven-day period surrounding the deal announcement. This finding implies that earlier research might have underestimated bidder gains, since markets usually price in some of the expected value of transactions before they are formally announced. The effect is particularly noticeable for acquirers that consistently pursue M&A or follow recognizable patterns (Tunyi, 2021). Some acquisitions are essentially investments in future innovation. When the buyer and target have patents that complement each other, the buyer pays more, but later sees stronger innovation (Li, 2016). This suggests long-term gains come from combining knowledge rather than immediate profits.

Even though the acquiring firm's stock price doesn't consistently increase when a deal is announced, numerous mergers still lead to better business performances afterwards

(Demirer & Karaduman, 2024). Demirer and Karaduman (2024) examine over 2 000 U.S. power plant acquisitions from 2000 to 2023 in which they found that fuel-adjusted efficiency increased by 2 % within five months of the transaction, and by 5 % when the buyer took over operations directly. Importantly, these efficiency gains were driven primarily by actual improvements in productivity, not only by acquiring higher performing plants. This shows that mergers can provide meaningful operational benefits, even when short-term market value for the acquirer is modest (Demirer & Karaduman, 2024).

Devos et al. (2009) add that even if the acquirer's stock doesn't move much on announcement day, the overall value of the merged firm tends to increase approximately 10 %. This is attributed to the fact that the benefits of the transactions, such as cost-savings, go to the combined firm, not only the acquirer. Since the acquiring firm's near-zero earnings can mean that the target firm receives most of the synergies through the premium, this doesn't mean that the deal would destroy the value (Devos et al., 2009).

Amihud and Lev (1981) explain that another reason behind certain mergers is executive risk. They claim that conglomerate mergers - where a company acquires other companies that are unrelated to its core business - can reduce the overall volatility of earnings. According to Amihud and Lev (1986), this diversification protects top managers, whose income depends heavily on company's performance, from substantial financial shocks. However, while this may serve managers, it doesn't necessarily benefit shareholders. In fact, such mergers usually fail to increase shareholder value and can diminish it by making the firm less focused and more complex (Amihud & Lev, 1981). Further research shows that this motive is particularly common in industries with heavy regulation or companies or where ownership is concentrated (Amihud & Lev, 1981).

3 Institutional details and case example

Merger and acquisition transactions typically follow a structured path according to Betton et al. (2008). First, the firms first make contact and sign an agreement. This is followed by a review of business, valuation and negotiation of terms. After this the deal is signed and publicly announced, then it undergoes regulatory review before closing and post-merger integration.

In research on M&A, examination of real-life cases provides valuable understanding of financial, strategic and competitive effects on these deals. Case analysis moves the discussion from theory to practice and explore how corporate decisions are made in real-world environments. The success or failure of a M&A is usually defined based on its effects on shareholder value. Deals that create lasting value are considered successful and those deals that reduce the value are regarded as unsuccessful (Moeller et al., 2005).

Institutional details, including method of payment and financing structures and the effectiveness of post-merger acquisitions are significantly important in this context. These elements aspects determine how value is shared between acquirers and targets, influence the success of synergy and guide the management of risks.

3.1 Method of payment and financing

Research on mergers and acquisition shows, the method of payments and how a deal is financed boils down to how the acquirer settles for the purchase - whether by paying cash, using their own shares or a combination of both (Travlos, 1987). It also involves how the payment is funded; internal cash, taking a new debt or issuing new stock. Travlos (1987) points out that the choice is rarely neutral, and it expresses relevant information about the acquirer's valuation of its own stock as well as its tax situation and tolerance for debt.

According to classic signalling theory, managers tend to raise cash when they believe their firm's shares are undervalued, and they prefer to issue new stock when they suspect overvaluation (Myers, 1984). According to Myers (1984), this leads to investors reacting negatively to equity offerings by lowering the stock price immediately. Omotesho and Obadire (2024) show that recent surveys from United Kingdom deals support the idea that companies that make all-cash bids, where the full payment is made in cash rather than shares, are more likely to create shareholder value than those paid with equity. They add that this causes minimal or no impact on their share price. In contrast, those that pay with equity usually face a decline of about 0,8 % around the announcement period (Omotesho & Obadire, 2024).

Financing considerations deepen the story. A carefully constructed study that looked at how state taxes went up at different times across United States showed that when taxes increase, companies are more likely to use debt to finance cash offers (Atanassov et al., 2018). According to Atanassov et al. (2018) the interest deduction from debt helps offset the risks of leverage, so the market doesn't punish them, and stock prices remain stable when the deal is announced. Conversely, when the acquiring firm's shares are highly liquid, using equity doesn't seem expensive. These acquirers often offer smaller premiums and avoid the common stock price hit linked to equity-financed transactions (Huang et al., 2024).

3.1.1 The choice of cash and tax field

Evidence from a recent quasi-natural experiment provides that tax incentives encourage companies toward debt-financed cash acquisitions without harming shareholder value (Atanassov et al., 2018). By leveraging staggered increases in U.S. state corporate tax rates from 1988 to 2012, Atanassov et al. (2018) report that tax-affected companies become 9,2 percentage-points more likely to undertake an acquisition and, once doing so, substantially more inclined to favour cash as a method of payment. The reason is clear: merging two balance sheets expands collateral, as a result enabling greater

borrowing capacity and strengthening the benefit from tax-deductible interest payments, known as the debt tax shield (Atanassov et al., 2018).

In line with this logic, Li (2016) explains the cumulative abnormal returns (CAR) don't differ statistically from zero around the announcement period. He says that CAR refers to an event-study measure to reflect changes in shareholder value, where a positive CAR indicates value creation and vice versa. This suggests that investors believe extra risk from more debt is fully balanced by tax benefits (Atanassov et al., 2018).

Omotesho and Obadire (2024) explain that the drop measures over a "-3 to +3" event window, which captures three trading days before the announcement (to catch any early information leaks), the announcement day itself and the three days after it, providing a full one-week perspective of the market's response. This observation confirms that investors pursue to treat equity as the more expensive option in modern mergers and acquisition transactions. Figure 3 shows how acquirer announcement returns over time.



Figure 3. The event window (days) around the acquisition announcement (adapted from Alexandridis et al., 2017).

Figure 3 is an event-study of acquirer stocks around mergers and acquisition announcements (Alexandridis et al., 2017). The y-axis is cumulative abnormal return (CAR) and the day 0 is the announcement day. In 2010-2015 (blue line), CAR remain close the zero before the news and rose approximately +3,5 % on the announcement day and stays positive for the following month, indicating clearly that the acquiring firms were rewarded (Alexandridis et al., 2017). By contrast, between 1990 and 2009 (orange line) CAR fell below zero even before the news and keeps falling to around -3 %, meaning that acquirers were punished by the market (Alexandridis et al., 2017). In their article Alexandridis et al. (2017) explains that earlier deals were viewed negatively, but in 2010, the reaction shifted clearly positive. They say that this change aligns with the latest evidence indicating that announcement window returns depend on deal characteristics such as the chosen payment method (Omotesho Obadire, 2024).

Tax attribute matters for both transaction feasibility and financing choice. Using staggered corporate income tax rates between 1988 and 2012, Atanassov et al. (2018) demonstrate that companies become more likely to pursue an acquisition, particularly those financed with cash. According to Atanassov et al. (2018) this is due to higher taxes increasing the value of interest deduction, making debt financing more attractive.

In his article, Jensen (1986) presents Free Cash Flow theory, which offers an understanding of how financing choices can affect managers' actions during M&A. He argues that when firms generate more cash than needed for profitable investments, managers might use the extra cash for acquisitions that reduce firm value, prioritizing their own influence rather than increasing shareholder wealth. Such acquisitions are consistently driven by managers' personal interests than by pursuit of efficiency. Jensen (1986) believes that more debt limits managers free cash flow, thereby encouraging more disciplined behaviour. He adds that taking on more debt can encourage financial discipline by forcing managers to focus on meeting repayment commitments. This pressure reduces wasteful spending and promotes more responsible investment decisions (Jensen, 1986).

3.1.2 Cash still beats stock in the 21st century

A review of 200 United Kingdom M&A cases announced between 2007 and 2009 by Omotesho and Obadire (2024) reveal that how a deal is paid for still shapes shareholder wealth. Firms that settled entirely in cash didn't see any abnormal share-price movement in their stock-price. But when bidders (the firms making the acquisition offers) used their own shares to pay, their stocks dropped by approximately 0,8 % (Omotesho & Obadire, 2024).

To demonstrate how significantly dominant cash financing is in the same UK sample, Table 1 provides categorization of payment methods. The data presented in Table 1 shows why Omotesho and Obadire (2024) that cash is both the most preferred payment method in recent UK acquisitions.

Table 1. Payment method in 200 UK deals (2007–2019) (adapted from Omotesho & Obadire, 2024).

Payment form	Number of deals	Share of total
Cash	173	87 %
Stock	8	4 %
Mix of both	19	9 %

Long-term tracking studies reveal an even more striking contrast. In their article, Loughran and Vijh (1997) document that acquirers using only stock to finance acquisitions underperform comparable companies by approximately 25 % over the five years after the deal closes, whereas bidders using cash tender offers enjoy strongly positive excess returns exceeding 60 %. Loughran and Vijh (1997) link this gap to differences in subsequent operating efficiency. Consistent with the overpayment narrative, Moeller et al. (2005) find that bidder announcement returns often decrease more rapidly as the size of the transaction relative to the bidder increases, especially

when equity is used instead of cash - both factors that diminish the acquirer's share in the value created.

Paying with shares only hurts when the value of those shares is uncertain to investors. The equity discount effect is minimal when the acquirer's shares are significantly more traded than the target's (Huang et al., 2024). Over 7 000 acquisitions announced from 1985 to 2018 showcase that when the liquidity gap between the bidder and the target increases by one standard deviation, companies can finance the transaction with approximately 4-5 percentage points more equity (Huang et al., 2024). This effect at the same time eliminates, or in some cases reverses, the normally negative announcement-period CAR that comes with stock offers (Huang et al., 2024). It's also noted in the article that the intuition is straightforward: if shareholders of target firm know they can resell the shares affordably and quickly, they no longer fear being paid in "overvalued stock", leading the market response to shift toward neutrality or become even slightly positive.

3.2 Post-merger integration as a determinant of value

Post-Merger Integration (PMI) represents as a key bridge between M&A strategy formulation and the ultimate realisation of shareholder value (Walter et al., 2024). According to Walter et al. (2024) this phase occurs after the legal approval on a merger or acquisition, during which acquiring and target firms merge their operations, systems and cultures to achieve the intended financial and strategic synergies. Although many studies on corporate acquisitions focus pre-deal financing and valuation decisions, empirical evidence consistently emphasize that the ultimate impact on shareholder value heavily depends on quality and speed of integration (King et al., 2004).

When post-merger integration is poorly managed, it can weaken expected outcomes through operational disruptions, cultural clashes and the loss of key talent, whereas successful integration can turn anticipated synergies into actual gains in market value and lasting long-term returns (Devos et al., 2009). Based on the Devos et al. (2009) findings, one of the core challenges in PMI lies in capturing synergies without overextending resources. Moeller et al. (2005) mention that major acquisitions can end

up destroying shareholder value if integration expenses and challenges outweigh the projected gains. This highlights the importance of integration planning, which prioritizes the value drivers identified during the due diligence phase.

Another factor determining the success of post-merger integration is cultural integration. Differences in corporate culture, decision-making processes and management styles can weaken collaboration and reduce post-merger performance (Morosoni et al., 1998). In the context of cross-border M&A, differences in national institutions can amplify cultural tensions, leading to delays in achieving synergies and weaker shareholder returns (Laamanen, 2007). Conversely, proactive cultural strategies have proven efficiently minimize integration risks and promote sustainable value creation (Walter et al., 2024).

Leadership and governance during PMI play an important role. Boards and senior management teams with previous integration experience tend to implement clear accountability systems, maintain synergy tracking mechanisms and step in quickly if integration goals are delayed (Walter et al., 2024). The quality of this management style is directly linked to shareholder value through better cost control, faster decision-making and more effective resource allocation.

From a financial market perspective, the success or failure of PMI is often immediately reflected in share prices (Travlos, 1987). As Travlos (1987) notes, markets react not only to the announcement of a deal, but also to subsequent signs of integration, such as restructuring announcements, asset sales and performance updates. Acquirers who communicate credible integration plans and early synergies are more likely to maintain or improve post-deal valuations (Walter et al., 2024).

However, the literature also shows that even well-managed post-merger integration doesn't guarantee positive shareholder outcomes in all situations (King et al., 2004). Macroeconomic cycles, industry conditions and the timing of transactions can all have an impact on corporate integration efforts (Ivashina & Scharfstein, 2010). For instance,

acquisitions made during economic downturns may encounter external shocks, such as reduced demand or credit constraints, that limit the acquirer's ability to realise synergies, even if internal execution is strong (Beltratti & Paladino, 2013). So, the true challenge comes after the merger, when uniting both sides can either bring those promised benefits or causes them to disappear - all depending on how effectively the sides collaborate and work as one.

3.3 Real-world cases in M&A

In general, case-studies help identify the drivers of deals success and failure. For example, Disney's acquisition of Marvel Entertainment in 2009 has been examined as a strategic investment decision that expanded the firm's intellectual property portfolio and strengthened its market position (Calandro, 2010). Microsoft acquired LinkedIn in 2016, the world's leading professional networking platform and integrated it into its broader business ecosystem (Fischer & Tinkelman, 2020). As reported by Fischer and Tinkelman, (2020) this acquisition was intended to strengthen Microsoft's position in enterprise solutions and professional services. Several industry analysts remained doubtful, questioning whether the \$26,2 billion investment would truly deliver the predicted financial and strategic returns (Fischer & Tinkelman, 2020).

While some mergers and acquisitions have created significant shareholder value, others have resulted in considerable value destruction. For instance, AOL's acquisition of Time Warner in 2000 is widely regarded as a failure (Healy, 2016). Healy (2016) explains that because firms faced difficulties in integrating their operations, strategic approaches and corporate culture, it led to big reduction in the value of the acquisition recorded on their books (Healy, 2016). Similarly, eBay's acquisition of Skype in 2005 ended poorly, losing much of its value and was eventually sold off (Gu & Lev, 2011). Gu and Lev (2011) state that it was because eBay was unable to integrate the internet telephony service into its core business model. They add that this revealed a weak strategic fit between the firms.

3.4 Case study: Facebook-Instagram merger

One significant example is Facebook's acquisition of Instagram, a deal that reshaped the social media industry and sparked debate about innovation, competition and shareholder value creation (Glick & Ruetschlin, 2019). This case provides an insight to examine how an established firm respond to a growing competitive threat (Shapiro, 2018).

Instagram was launched in 2010 as a mobile-based photo-sharing application, when Facebook was still mainly a desktop-based platform (Glick & Ruetschlin, 2019). Shapiro (2018) notes that in less than two years, Instagram's user base grew extremely fast, reaching over 30 million users. Instagram's popularity on iOS and later Android meant it had the potential to attract users away from Facebook. Instagram posed a threat to Facebook's weaknesses, as Facebook suffered to align in the smartphone era, especially with its transition from HTML5 to native apps (Glick & Ruetschlin, 2019).

In April 2012, Facebook announced its 1-billion-dollar acquisition of Instagram, only weeks before Facebook's Initial Public Offering (IPO) (Glick & Ruetschlin, 2019). IPO is when a firm sells shares to the public for the first time, often through a stock exchange. This allows the firm to raise funds by selling a portion of ownership to investors. It also marks the shift from being privately held firm to becoming publicly traded. The high price (\$1 billion) raised eyebrows, given that Instagram had no meaningful revenue at the time, but its impressive growth on mobile made the high price seem justifiable (Glick & Ruetschlin, 2019).

CEO and founder of Facebook Mark Zuckerberg announced the following about the deal:

I'm excited to share the news that we've agreed to acquire Instagram and that their talented team will be joining Facebook - This is an important milestone for Facebook because it's the first time we've ever acquired a product and company with so many users. We don't plan on doing many more of these, if any at all. But providing the best photo sharing experience is one reason why so many people love Facebook, and we knew it would be worth bringing these two companies together... (Zuckerberg, 2012).

While this public statement presented the deal as a joint effort to improve photo-sharing capabilities, Glick and Ruetschelin (2019) argue that the acquisition was also a strategic move to eliminate a fast-growing competitor. According to them, Instagram was more than just a complement to Facebook; it was a potential competitor capable of challenging Facebook's users or even become a direct alternative social network. Because both Instagram and Facebook provided free services, the focus of competition isn't on price, but rather on user engagement (Glick & Ruetschlin, 2019). To conclude, Instagram, having built a loyal growing audience, particularly among young people, posed a threat to Facebook's market dominance (Glick & Ruetschlin, 2019).

Shapiro (2018) takes this viewpoint further, saying that Facebook's leadership internally recognized Instagram's potential to undermine its position in the social media field. He points out Instagram's high engagement rate, its popularity among young users and its ability to respond to changing user preferences made it a remarkable challenge. In Shapiro's (2018) view, this merger enabled Facebook not just to integrate a rapidly growing platform, but also to remove a direct threat. In doing so, it strengthened its market position and eliminated the threat of long-term weakening of its competitive position.

This case-study illustrates how a well-timed acquisition can both increase a firm's main products and remove a major competitor. It emphasizes the complex relationship between official firm reports and the deeper strategic intentions and offers valuable insights into how M&A can effect long-term market dynamics. From a shareholder value perspective, the Facebook-Instagram merger can be seen as a success. Even though the market's early reaction was cautions, over the time the transaction created significant long-term value by enhancing Facebook's market position and supporting sustainable growth in share price.

4 Evidence from literature

When it comes to judging whether an acquisition is a smart decision, the key question is: will this benefit the acquiring firm's shareholders? Research reveals that, in many cases, it doesn't (Li, 2016). Research indicates that, on average, acquiring public firms experience only a small positive and occasionally even negative stock market reactions, whereas target firms often benefit from the acquisition premium (Li, 2016).

4.1 General evidence on target and acquirer returns

According to Moeller et al. (2005), on average, shareholders of acquiring companies can suffer value loss, particularly when the deals involve very large companies or "mega-deals". They examine acquiring-firm shareholders outcomes during a merger wave in the late 1990s and early 2000s. It focuses on whether large acquiring firms consistently experience weaker stock outcomes than smaller acquirers. They also estimate, that in certain merger waves, shareholders may face considerable overall losses, questioning the belief that larger acquisitions automatically lead to higher synergies. But sometimes, achieving these benefits can be challenging. Moeller et al. (2005) highlight that shareholders can face significant financial losses, especially when mega-acquisitions fail to achieve expected synergies.

Alexandridis et al. (2017) extend this line of research by exploring more recent mergers, concentrating on how acquisition premiums and deal size relate to shareholder returns. Their findings indicate that larger transactions tend to involve higher acquisition premiums, which can reduce acquirer gains if expected synergies fail to materialize. This suggests that overpayment is a key factor behind weak post-acquisition performance. Post-acquisition means the period after the transaction has been completed. Moeller et al., (2005) reveal that large acquirers often underperform, reinforcing the idea that deal size plays a crucial role in gains – aligning well with the findings of Alexandridis et al., (2017).

4.2 M&A and shareholder value during the Financial Crisis

Merger and acquisition activities mirrors the economic cycle, as overvaluation and liquidity expansions produce waves of deal-making (Rhodes-Kropf & Viswanathan 2004). Historically, the value and number of acquisitions have followed economic cycles - during upturns, the M&A market becomes more active, while in times of downturns it slows down (Rhodes-Kropf & Viswanathan 2004).

The global financial crisis 2007-2009 offers a clear example of how a macroeconomic shock interrupted M&A activity, reduced deal volume and temporarily depressed acquirer returns before a disciplined recovery (Beltratti & Paladino, 2013). According Beltratti and Paladino (2013) before financial crisis, corporate acquisitions were being made at a record pace: high valuations and cheap financing. The M&A boom of mid-2000s was characterized by excessive optimism, easy access to a cheap credit and high market valuations, which led many acquirers to pay excessive premiums for targets (Moeller et al., 2005). However, as Moeller et al. (2005) indicate, acquirers often failed to reward their own shareholders with near-zero or negative bidder announcement returns.

When the crisis hit, the trend reversed sharply - growing uncertainty, a deepening credit crunch and declining confidence among business leaders led to a sharp decline in the number of corporate acquisitions following the financial crisis (Beltratti & Paladino, 2013). Moreover, liquidity disappeared, and credit conditions tightened significantly, weakening firms' ability and willingness to pursue M&A due to limited access to external funding (Ivashina & Scharfstein, 2010). At the same time, financially constrained companies responded by delaying or cancelling acquisition and investment plans, further suppressing M&A activity (Campello et al., 2010).

According to Moeller et al. (2005) these conditions left acquirers with little to no abnormal returns, or even losses around the deal-announcements, suggesting a value shift favouring target shareholders over the buyers. Research from that era suggests that

M&A booms driven by excessive optimism and easy credit often harm shareholder value for acquiring firms, particularly when enthusiasm overshadows valuation discipline (Moeller et al., 2005). This situation emphasizes the fundamental risks of pursuing acquisitions in periods of abundant liquidity, where competitive pressure and overvaluation can push acquirers to overextend themselves strategically.

Once credit markets stabilised, however, disciplined, well-capitalised acquirers took advantage of reduced valuations (Alexandridis et al., 2017). As stated by Alexandridis et al. (2017) by 2013-2014 global deal values and counts had risen past their pre-crisis peaks, restoring positive bidder returns in the process. Over the long run, M&A remains cyclical yet persistent mechanism for corporate growth and restructuring, rising and falling with macroeconomic liquidity but repeatedly reclaiming a central role (Rhodes-Kropf & Viswanathan 2004).

5 Conclusion

Mergers and acquisitions remain one of the most discussed strategies in corporate finance. They are usually praised for their potential to create value and transform firms, yet equally criticised for their risks and disappointments they can cause. This thesis explores how such deals effect shareholder value by connecting established theories with empirical evidence and real-world case-study. The analysis incorporated insights from agency theory, behavioural finance and market efficiency to explain strategic reasons behind mergers and acquisitions, the psychological forces that shape investor reactions and the fundamental challenge in determining whether true value has been created.

This thesis addressed three hypothesis. The first hypothesis concerned how value is distributed between the shareholders of the acquiring firm and target firm. The results confirm this hypothesis: the shareholder of the target firm often benefit through positive abnormal return. The results of the acquiring firm usually differ, often neutral or sometimes even negative in the short run.

The second hypothesis dealt with the role of financing. This hypothesis is supported by the fact that cash payments are generally received more positively in the market. They signal management's confidence in the transactions, while share-based payments may cause uncertainty unless accompanied by a clear and transparent justification. Debt financing plays a crucial role as it helps the management use firm cash carefully, as suggested by the Free Cash Flow -theory.

The third hypothesis was about the role of post-merger integration as a determinant of value creation. This hypothesis is partly supported. The findings show that value creation isn't guaranteed and depends mostly on the quality of integration. When integration is poorly managed, the expected synergies can easily disappear, while well-implemented integrations can deliver remarkable long-term shareholder value. The case example of Facebook-Instagram shows how effective integration can result in lasting value gains.

However, integration alone cannot guarantee success, because market conditions and managerial motives can reduce potential benefits. Sometimes, even with good integrations value creation is limited.

All in all, the study concludes M&A have the potential indeed to enhance shareholder value, but success is neither guaranteed nor automatic. It highly depends on having clarity of disciplined execution, the right financing setup, well-defined strategic goals and the capability to manage investor expectations with what's happening operationally. For managers, this underscores the importance for careful analysis before the transaction and ongoing, honest communication. In the end, the true success of M&A lies not in the size of the deal or the headlines it grabs, but by its ability to create lasting value to shareholders - a goal that demand discipline, focus and patience to let results speak over time. For future research, it will be valuable to look at how integration is done in different industries, since the post-merger section often determines if expected benefits happen or not.

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