Abstract
Mergers are the mechanisms that redraw the boundaries of the firm. In this paper, we relate incomplete contracts, upon which much of our understanding of firm boundaries is based, 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.