IMPACT OF ACQUISITIONS ON SHORT- AND LONG-TERM VALUE CREATION AT MICROSOFT CORPORATION, PERIOD OF 2011 – 2021

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ABSTRACT

Companies perform mergers and acquisitions to grow, either horizontally by way of new products, or vertically across the value chain. Mergers and acquisitions are a widely used growth strategy for various industries, moreover in the global information technology sector. Microsoft Corporation (NASDAQ: MSFT) has used mergers and acquisitions as an integral part of their business strategy to either acquire new products, enhance the the capabilities of existing products, or to serve a new business segment. Studies and evaluations of the impact of mergers and acquisitions normally assess long-term financial performance or short-term returns. The former usually measures value creation for the compay, while the latter measures value creation for shareholders. This study attempts to assess both short-term value creation via abnormal returns using four sample acquisitions and long-term value creation by way of financial ratio analysis to better understand how Microsoft Corporation creates value for shareholders and the company. The study found that most acquisitions do not create short-term value for shareholders and the company, this mostly happens in the long run. The results support the efficient market hypothesis. Furthermore, this study can be used as reference for managers on how to create value for shareholders and the company via acquisitions. Integrating the acquisition into one's product portfolio to build strong product experience appears to have more bearing on value creation for shareholders and the company.

Keywords*:* Abnormal returns, event studies, financial ratio analysis, mergers and acquisitions.

INTRODUCTION

Mergers and acquisitions (hereinafter abbreviated as M&A) are a widely used business strategy across various industries (Brealey, Myers, & Allen, 2019). Companies perform M&A for various goals, which may include better serving existing markets, or obtain capabilities to enter new markets, obtaining new capabilities, products, or new employee skillsets, or reaching economies of scale, in a manner faster than building the capability internally (Candra et al., 2021; Zulbainarniet al., 2021). Some industries have seen more frequent mergers and acquisitions compared to other industries, such as the global information technology industry where companies may acquire several other companies on a yearly basis. This is commonly known as serial acquisitions (Croci & Petmezas, 2009; Andrews, 2022).

The motiviation to perform mergers and acquisition has also been the subject of multiple studies (Adavikolanu, 2008; Chen, Chun, & Kun, 2013; Croci & Petmezas, 2009). At an enterprise level, the motivation for companies to perform mergers and acquisitions vary, from gaining new technology capabilities, creating operational efficiencies, or gaining new markets (Usman, 2011; Rahman, Ali, & Jebran, 2017). Studies have also found that at a managerial level, M&A motivation also vary; it could be part of the enterprise's business plan, or it could be a way for managers to retain money in the company instead of giving it back to shareholders (Chen, Chun, & Kun, 2013; Paskelian, Bell, & Rao, 2014).

Extant studies have assessed how does M&A impact value creation, or value destruction, for the acquiring company (Renneboog & Vansteenkiste, 2019). Roll, M (2014) posited that M&A may ultimately lead to value destruction for the acquiring firm. This stems from both financial and technical issues, the former may arise from overvaluation or greed, while the latter stems from the fact that subsequent integrations distract managers from daily operations (Roll, M., 2014). This view is also corroborated by Irawan & Edi (2021) and Agrawal &Jaffe (1999). Agrawal & Jaffe (1999) conducted empirical tests which found that high profile or glamorous target companies are initially overvalued, leading to negative long-run performance after the acquisition. The opposite however also holds true, that is low profile target companies are initially undervalued, leading to long-run positive performance.

There are two widely used methodologies to evaluate value creation by way of M&A (Renneboog & Vansteenkiste, 2019). The first is short-term studies, using efficient market hypothesis as the underpinning, and therefore uses share price and abnormal returns to measure value creation (Rahman, Ali, & Jebran, 2017). The second is long-term studies measure company financial performance, and therefore uses financial results as a measure of value creation (Daryanto, Alfathan, & Siregar, 2020; Putri, 2012). While there have been extensive studies on the long- and short-term impact of mergers and acquisitions across various industries and countries, there has been limited studies aimed at understanding how global technology companies, an industry where serial acquisition is common practice, create value through acquisitions.

Established in 1975, Microsoft Corporation is a leading technology company with a valuation, at the time of writing, of around USD 2.4 tillion (www.companiesmarketcap.com, 2023). M&A has been an integral part of Microsoft's business strategy, leveraged by every CEO in office. Between 2017 to 2020, Microsoft acquired 40 companies. Table 1 provides a snapshot of acquisitions that Microsoft has performed. Their first acquisition was Forethought Inc., purchased in 1987, which became the predecessor of Microsoft Powerpoint (Cochrane, 2004). Bill Gates and Paul Gardner Allen founded the company, with Bill leading the company

until the year 2000. During this period, Microsoft's main products were its Microsoft Windows operating system, Office productivity suite, and various enterprise software solutions.

Bill Gates was replaced by Steve Ballmer, who was in office until 2014. Steve Ballmer's leadership was dubbed by analysts as the lost decade (Ibarra, Rattan, & Johnston, 2018), marked by dwindling share prices and financial performance. In 2014, Satya Nadella was appointed CEO. According to analysts, the major change he brought was changing the mindset and culture of the company. This allowed for Microsoft to undertake major changes which reinvigorated their business, engaged a wider range of user base, and ultimately led to increased share prices (Ibarra, Rattan, & Johnston, 2018). Chief among this, was diversifying their revenue streams, and building new products, services, and overall ecosystem.

Table 1: Snapshot of Microsoft's Acquisitions

Company	Year	Value	Acquisition Outcome	Reference
Forethought Inc.	1987	USD 14 million	Built into MS Visio	Cochrane, 2004
Hotmail.com	1997	USD 500 million	Email services later changed into outlook.com	Pelline, 1997
Navision	2002	USD 1.33 billion	Built into MS Dynamics	Ngelaine, 2005
Skype Technologies	2011	USD 8.5 billion	Established as new division within Microsoft	Swisher, 2011
Nokia	2013	USD 7.2 billion	Designed to enter the smartphone market	Microsoft, 2013
LinkedIn	2016	USD 26.2 billion	Retained as a distinct brand	Microsoft, 2016
GitHub	2018	USD 7.5 billion	Retained as a distinct brand	Microsoft, 2018
RiskIQ	2021	USD 500 million	Integrated into existing cybersecurity offerings	Microsoft, 2021

RESEARCH OBJECTIVES

There are two research objectives of this study.

1. Understand Microsoft's long-term financial performance, from 2012 to 2021.
2. Analyze whether the mergers and acquisitions that Microsoft performed led to short-run value creation for shareholders?

LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

Studies on short-term impact of mergers and acquisitions have two main underpinning studies, efficient market hypothesis, and hubris theory. Efficient market hypothesis (Fama, Fisher, Jensen, & Roll, 1969) states that markets quickly absorb various information related to a stock as soon as it becomes available. As such, various positive or negative corporate events such as board reshuffles, product launches, mergers and acquisitions, or product recalls, publicity debacles, or product failures impacts the stock price of a company. There are three forms of market efficiency, weak, semi-strong, and strong forms (Fama, Fisher, Jensen, & Roll, 1969). The weak form assumes that all past information has been reflected in today's stock price, hence technical analysis cannot be used to predict the market. The semi-strong form implies that fundamental analysis may lead to achieving better-than-market returns, as all publicly available information is reflected in stock prices. Lastly, the strong form implies that stock prices incorporate all available information, hence it is impossible to achieve better-than-market returns using either technical or fundamental analysis.

The second theoretical foundation for evaluating stock price performance is hubris hypothesis (Roll R., 1986). This theory posits that there are behavioral and psychological aspects that influence managers in making M&A decisions. The behavioral aspect relates to managers working in their own self interest, instead of maximizing shareholder value. This includes using available funds to perform mergers and acquisitions instead of paying back shareholders. The psychological aspect relates to the process of bidding for a company. As managers serve their own interests, they might overpay for a company. This results in the combined entity being overvalued, destroying value for shareholders, while maximizing personal gains for management. Hubris hypothesis assumes the strong form of market efficiency; all public and non-public information are fully reflected in the stock price of a company. As such, the valuation of a company fully reflects all available information and is the fair bidding price. Pricing beyond this point is considered as a premium. Given this characteristic, hubris hypothesis is deployed as the null hypothesis for various studies evaluating mergers and acquisitions.

Long-term studies use financial ratios as a proxy to measure changes before and after an M&A has taken place (Daryanto, Alfathan, & Siregar, 2020; Putri, 2012). The use of financial ratios allows for the examination of changes in a company's profitability, solvency, liabilities, activities, and shareholder wealth creation over a certain time period. The downside of this approach is that it cannot be used to measure the impact of multiple acquisitions, as changes in business results cannot be compartmentalized based on a particular acquisition. Given the different characteristic of long-term financial performance with short-term abnormal returns,

the latter will be used to examine return changes during select acquisitions, while the former will be used to uncover the wider trends in the business.

Thus, the hypotheses for this research are as follows:

H1: There is a difference in Microsoft's stock price between actual returns and abnormal returns caused by Microsoft's acquisition announcement of Nokia.

H2: There is a difference in Microsoft's stock price between actual returns and abnormal returns caused by Microsoft's acquisition announcement of LinkedIn.

H3: There is a difference in Microsoft's stock price between actual returns and abnormal returns caused by Microsoft's acquisition announcement of GitHub.

H4: There is a difference in Microsoft's stock price between actual returns and abnormal returns caused by Microsoft's acquisition announcement of RiskIQ.

RESEARCH METHODOLOGY

The measurement of long-term value creation will employ financial ratios over the period of 2011 to 2021. There will be five main categories of financial ratios for this study. The first is profitability ratios and will be measured via return on equity, return on assets, and net profit margins. The second is liquidity ratios, measured through cash and current ratios. The third is activity ratio, measured by asset turnover. Total equity to total assets, and debt to equity ratios will calculate solvency ratios, the fourth category. The fifth is shareholder wealth creation, and measures price-earning ratio, dividend yield ratio, and dividend payout ratio. The source of data for these calculations will be Microsoft Corporations' financial reports of the period.

Short-term value creation will be calculated using event studies to measure abnormal returns from four select acquisitions that Microsoft Corporation performed between 2011 to 2021 that are listed in Table 2 (Shanaev & Shuraeva, 2020). The criteria for these acquisitions are as follows. First, they occurred between 2011 to 2021. Second, they should represent standard product enhancements, and high-profile business leaps.

Table 2: Sample acquisitions for this study

Event	Acquisition	Announcement Date	Type of Acquisition
Event 1	Nokia	September 2nd, 2013	Horiziontal acquisition, enter smartphone market
Event 2	LinkedIn	June 13th, 2016	Horizontal acquisition, enter social media industry
Event 3	GitHub	June 4th, 2018	Horizontal acquisition, enter new market segment (developers)
Event 4	RiskIQ	July 12th, 2021	Horizontal acquisition, enhance existing cybersecurity products

Figure 1: Timeline for event studies

The source of data for event studies will be Microsoft share prices surrounding the announcement date as well as the NASDAQ technology index (NDTX). A total of 31 days will be used to measure the announcement effect, 15 days for the pre-event anticipation period, one day for the announcement date, and another 15 days for the post-event adjustment period (Krivin, Patton, Rose, & Tabak, 2003). Another 31 days of stock prices prior to this period will also be used as the benchmark period. Abnormal returns will be calculated using cumulative and buy-hold abnormal returns, the former provides a simpler calculation model, while the later although slightly more complex is able to better simulate investor behavior.

Risk-adjusted market model will be the method to calculate abnormal returns for this study. This model factors in returns, volatility, and market risk (El Ghoul, Guedhami, Mansi, & Sy, 2023; Shanaev & Shuraeva, 2020). Studies found that the market model reduces variance in abnormal returns by removing sources of variations in market returns.

Table 3: Variables for this study

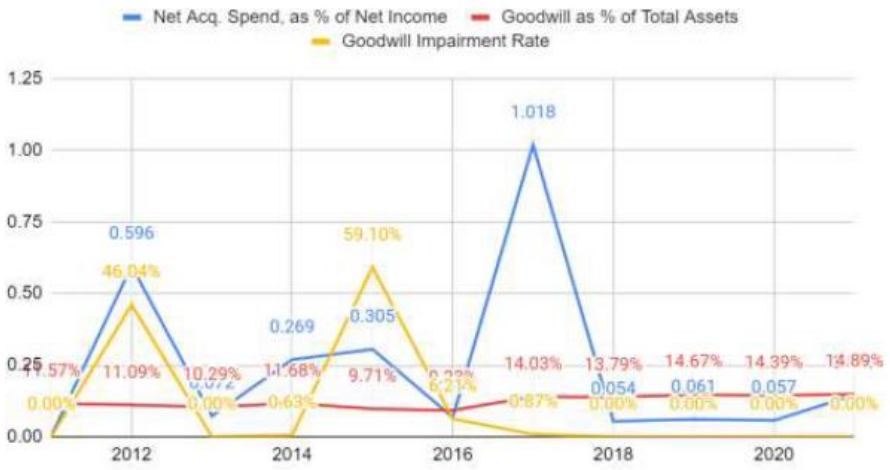
No	Variable	Reference	Formula
1	Return on assets		*Net Income* / *Total Assets*
2	Return on equity		*Net Income* / *Total Equity*
3	Net profit margin		*Net Income* / *Net Sales Revenue*
4	Cash Ratio	(Daryanto, Alfathan, & Siregar, 2020, Putri, 2012)	*(Cash+Cash Equivalents)* / *Current Liabilities*
5	Current Ratio		*Current Asset* / *Current Liabilities*
6	Asset Turnover		*Revenue* / *Total Assets*
7	Total Equity to Total Assets		*Total Equity* / *Total Assets*
8	Debt-Equity Ratio		*Total Liabilities* / *Total Equite*
9	Price-Earnings Ratio	(Martin, Keown, & Titman, 2011)	*Price per Share* / *Earning per Share*
10	Dividend Yield Ratio	(Martin, Keown, & Titman, 2011; Ross & Stapleton, 2022; Wild et al., 2012)	*Annual dividends per Share* / *Price per Share*
11	Dividend Payout Ratio	(Martin, Keown, & Titman, 2011; Tamrin, Mus, Sudirman, & Arfah, 2017; Zhang, 2013)	*Annual dividends per Share* / *Earnings per share*
12	Risk-Adjusted Market Model	(El Ghoul, Guedhami, Mansi, & Sy, 2023; Shanaev & Shuraeva, 2020)	$Rst - (\alpha + \beta \; x \; Rxt)$ *Rst:* realized returns of stock *s* at time *t*. α: returns of stock *s* during the period of the event study. β: market volatility. *Rxt*: returns of index *x* during time *t*.

RESULTS AND ANALYSIS

MICROSOFT CORPORATION'S ACQUISITION PATTERN

Figure 2 depicts Microsoft Corporation's acquisition pattern for the observation period. Net acquisition spend as a percentage of net income has seen peaks and and troughs throughout the observation period, but never reaching zero. Thus, Microsoft performs several acquisitions annually. Goodwill as a percentage of total assets has constantly floated between 10% to 15%, suggesting that Microsoft pays premiums for M&As. Goodwill impairment has been mostly near 0% save for 2012 and 2015, the latter was when Microsoft divested Nokia. As divestments are a rare case, this suggests that Microsoft has strong capabilities in planning, acquiring, and integrating target companies into their business strategy.

Figure 2. Microsoft's acquisition, goodwill, and goodwill impairment, 2012-2021 (source: Author, 2023)



Long-Term Value Creation, Financial Ratio Analysis

Microsoft experienced several dips and climbs in profitability, with near similar figures at the beginning and end of the observation period (Figure 3). Total equity, total assets, and net income nearly tripled over this period. The three largest contributors to asset growth included short-term investments, almost triple growth, forming 35% of total assets. Property, plant, and equipment grew sevenfold, forming 18% of total assets, and could be testament of their transition to cloud computing. The third is goodwill, which grew more than four times and contributes 15% of total assets. Equity growth was fueled by growth in retained earnings which grew ten times.

Figure 3. Microsoft's NPM, ROE, and ROA, 2012-2021 (source: Author, 2023)

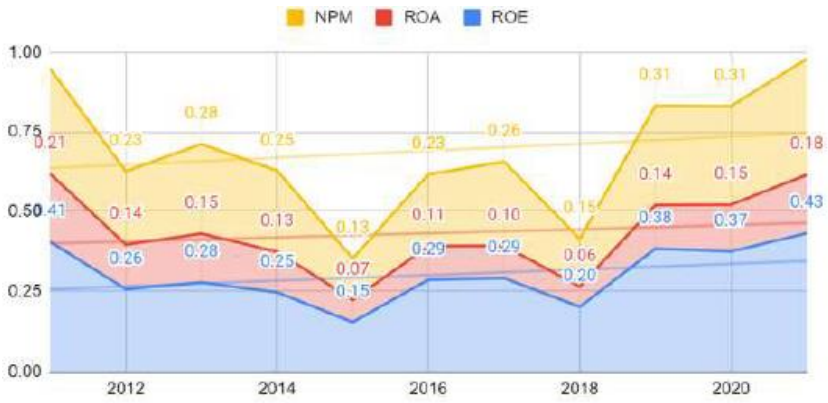
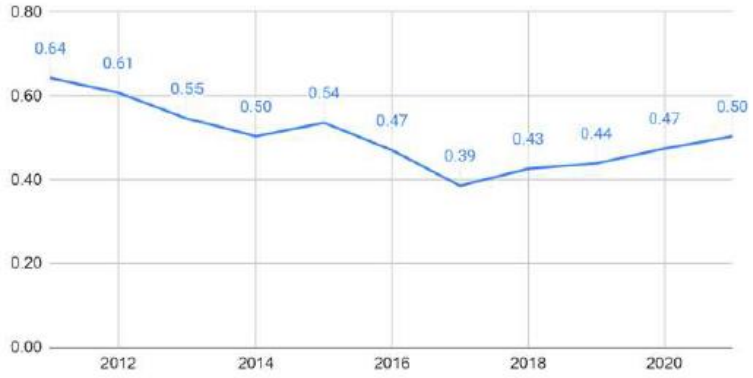


Figure 4 shows how liquidity ratios have changed over the observation period. Microsoft's cash ratio, has been mostly between 0.1 to 0.2. Microsoft's current ratiohas contantly been between 2.5 to 2.08, constantly decreasing in the past three years of the observation period. This indicates that Microsoft has been working increase their working capital efficiency, and mitigate risks of having too much cash in hand. This assumption is further corroborated by their much higher current ratio, and also from the growth of their short-term investments during the observation period. The growth of trade receivables over the same period may also indicate increasing adoption of their Azure cloud computing business.

Figure 4. Microsoft's Cash and Current Ratios, 2012-2021 (source: Author: 2023)

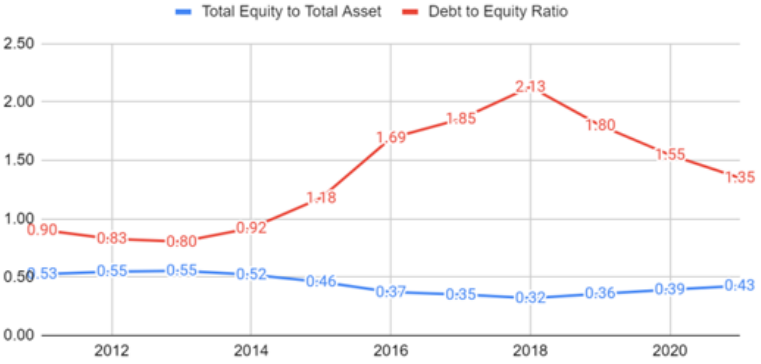
Microsoft's asset turnover has constantly been around 0.64 to 0.5, as revenue growth was dwarfed by total asset growth. This growth in assets could be indicative of additional assets they need to own and operate to provide cloud services. Low asset turnover rates are common for companies with large assets bases and low-to-medium sales volumes, such as telecommunications, and utilities.

Figure 5. Microsoft's Asset Turnover Ratio, 2012-2021 (source: Author, 2023)



Microsoft's solvency ratios highlight a growing trend of debt-based financing. TETA and DER values at the initial years only had a minute difference. The values diverged in 2014 with TETA ratios nearly constant, while DER soared. The reason is equity grew at a slower rate of 10% to 15% year on year, while debt grew between 15% to 20% year on year. By the end of the observation period, long-term debt and long-term income tax contributed 29% and 14% of total debt, respectively. The contributors for total equity were common stock contributed and retained earnings, contributing 58% and 40% of total equity.

Figure 6. Microsoft's Solvency Ratios, 2012-2021 (source: Author, 2023)



Shareholder wealth creation consists of three ratios, price-earning, dividend yield, and dividend payout ratios. Price-earning ratios, Figures 7, have grown over the period, while dividend yield, Figures 8, has been nearly constant, and dividend payout has declined. The reason for this is Microsoft's share prices grew ten times over the observation period while earnings and dividends per share grew four times over the same period. The price-earning ratio shows that the market has been appreciative of Microsoft's growth. Dividend payout has seen more cyclicality, implying that Microsoft has retains and disburses earnings periodically. The stable decline of dividend yield implies that price per shares have outgrown dividends paid, and that dividend investors might earn similar results at stocks at lower prices.

Figure 7. Microsoft's Price-Earnings Ratios, 2012-2021 (source: Author, 2023)

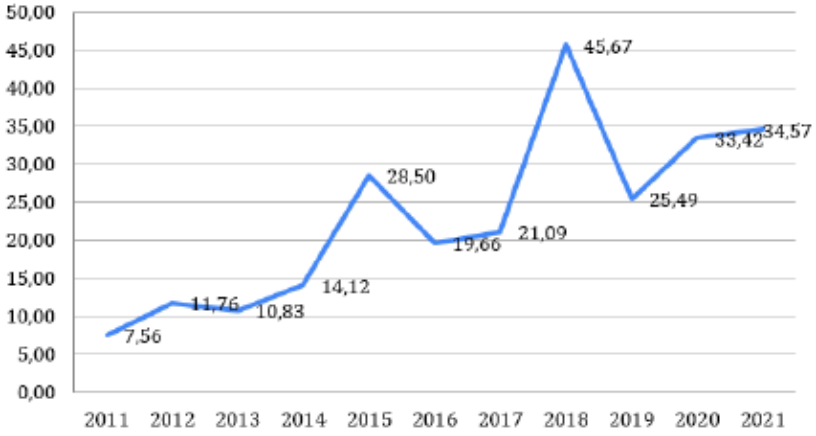


Figure 8. Microsoft's Dividend Yield and Dividend Payout Ratios, 2012-2021 (source: Author, 2023)

Short-Term Value Creation, Event Studies

Microsoft's stock returns were calculated for the event period in three main groups, the pre-event anticipation, and post-event adjustment period of 15 days each, and the event day itself.

Table 4: Summary statistics of average stock returns before and after acquisition

Event	Acquisition	Pre-Event	Event Day	Post-Event
Event 1	Nokia	0.13%	-4.56%	0.21%
Event 2	LinkedIn	0.15%	-2.59%	0.16%
Event 3	GitHub	-0.21%	0.87%	0.23%
Event 4	RiskIQ	0.18%	-0.22%	0.43%

Cumulative abnormal returns of the stock prices were computed using the risk-adjusted market model to know how the acquisitions impacted shareholder value creation. Table 5 shows how both abnormal and benchmark returns change in average for pre-and post-event returns as well as on the event day. Some abnormal returns performed better than benchmark returns, on other occasions the opposite held true.

Table 6 provides a summary of hypothesis testing across the four events. Despite the apparent abnormal returns for all four sample acquisitions, statistically significant abnormal returns were evident only on the event day of the Nokia acquisition with a p-value of 0.05.

Table 5: Abnormal and benchmark returns, risk-adjusted market model

Acquisition		**Pre-Event**	**Event Day**	**Post Event**
Nokia (event 1)	Abnormal Returns	0,24%	-4,30%	0,40%
	Benchmark Returns	0,43%	-11,29%	0,32%
LinkedIn (event 2)	Abnormal Returns	0,35%	-2,11%	0,07%
	Benchmark Returns	0,35%	-0,54%	-0,32%
GitHub (event 3)	Abnormal Returns	-0,09%	0,08%	0,06%
	Benchmark Returns	-0,28%	1,70%	0,17%
RiskIQ (event 4)	Abnormal Returns	0,22%	-0,33%	0,00%
	Benchmark Returns	-0,02%	-0,31%	0,04%

Table 6: Summary of hypothesis testing

Acquisition		**Pre-Event**	**Event Day**	**Post Event**
Nokia (event 1)	T-stat	0.72	**-1.98***	0.43
	P-value	0.47	**0.05***	0.67
LinkedIn (event 2)	T-stat	0.22	-1.71	1.08
	P-value	0.83	0.09	0.28
GitHub (event 3)	T-stat	0.32	0.12	-0.48
	P-value	0.75	0.91	0.63
RiskIQ (event 4)	T-stat	1.25	-0.48	-0.01
	P-value	0.21	0.63	0.99

CONCLUSION AND RECOMMENDATIONS

Conclusions

1. Three out of four sample acquisitions did not create value for shareholders in the short-term.
2. Value creation for shareholders was more apparent in the long-term as seen by increases in price-earning ratios.
3. Price-earnings appreciation was the main driver of shareholder wealth creation, whereas only a small fraction of earnings was disbursed as dividends.
4. Value creation for the company happens in the form of improved profitability.
5. Microsoft's value creation strategy comes at a cost of increasing liabilities, as evident from their solvency ratios.

Recommendations

Recommendation for academia

1. Expand the test subject to multiple companies, either in the same or different industries, to better understand how various companies utilize M&A to create value.
2. Examine impact of M&A funding source, such as debt-financed against equity-based acquisitions, towards post-acquisition performance.
3. Examine acquisition-related accounting entries, such as goodwill, goodwill impairment, net acquisition spending towards revenue and shareholder wealth creation.
4. Examine the cross-functional impact of M&A towards enterprise-wide integration, such as human resources, information technology, etc.
5. Examine M&A integration strategies that impact post-acquisition success or failure.

Recommendations for businesses

1. Managers should build a grand design for product and brand experience, and identify how to enhance such experience either internally or externally, by way of M&A.
2. Managers should set benchmarks and build guidelines on best practices for the funding and valuation of M&A, as target companies will normally sell for a premium.
3. Managers should also devise methods to integrate acquisitions at both enterprise- and product-level. This is an area that Microsoft performs well, enhancing their brand experience.
4. In view of Microsoft's asset turnover trend, where fixed assets have grown considerably during the observation period, managers might want to set decision criteria on when to manage assets internally and when to offload work, i.e data center management and operations, to a strategic partner to improve their fixed assets and asset turnover posture.

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