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M&As Are A-Okay

How Mergers and Acquisitions Help Entrepreneurs and Drive Innovation

*By Jessica Melugin**

> *"If economists wished to study the horse, they wouldn't go and look at horses. They'd sit in their studies and say to themselves, 'What would I do if I were a horse?'"*
>
> \- Ronald Coase, quoting fellow economist Ely Devons[1]

Fretting about "killer acquisitions" and "kill zones" is common among regulators in Washington these days, but entrepreneurs and investors at work in the tech industry intrinsically understand the myriad benefits of mergers and acquisitions (M&A) for founders, buyers, and end users. The economic evidence does not support new regulations to prevent or curtail mergers and acquisitions. Rather, it aligns with the positive experience of tech entrepreneurs and investors in the marketplace.

A "killer acquisition" occurs when a market leader purchases a would-be competitor only to shut down the threatening product. This not only deprives consumers of that particular product or service, but goes on to harm competition at large by deterring investment in that area, thereby creating a "kill zone."

These antitrust concerns, along with others, have prompted calls for increased regulatory scrutiny of M&A activities. For example, U.S. Senator Elizabeth Warren (D-MA) introduced legislation prohibiting mergers valued in excess of $5 billion or those resulting in a market share greater than 33 percent total or 25 percent of any labor market.[2] Additionally, the Federal Trade Commission, under the leadership of Chair Lina Khan, is rewriting its rules for mergers with the aim of deterring the practice.[3]

But the story of killer acquisitions and kill zones has an alternative narrative to explain the motivation and net benefits of big tech M&A. The lesson here is that mergers and acquisitions are a feature, not a glitch, of a healthy, competitive, and innovative tech sector.

While it is easy to see the temptation for a market leader to buy up a potential competitor to kill its threatening innovation, the feasibility of that happening is low. Very few, if any, leading firms have the vast financial resources to purchase every potential competitive threat that comes along. Certainly, there are instances of companies buying smaller firms and spiking their technology, but there is also a healthy financial incentive for the acquiring firm to make good use of the attendant purchased products or skills by offering them to

* *Jessica Melugin is director of technology and innovation policy at the Competitive Enterprise Institute. She would like to thank Stephen Forte, Parag Shah, and Vishal Singh for generously sharing their firsthand experiences and observations of the tech entrepreneurial and venture capital world. The views and opinions expressed in this paper do not necessarily reflect their views or the views of the entities they represent.*

consumers. The gains for consumers in those situations should not be ignored. That the stifling practice may happen sometimes shouldn't thwart the more productive acquisitions that make up the vast majority of transactions.[4]

Facebook's acquisitions of Instagram in 2012 and of WhatsApp in 2014 are good examples that provide empirical justification for continued allowance of acquisitions. Consumers, competition, sellers, and buyers are all better off because of those acquisitions.

Facebook eliminated WhatsApp's download and subscription fees, producing the consumer benefit of reduced cost and raising its user base to 2 billion today.[5] Facebook, with its superior resources, was able to transform Instagram's glitchy and unprofitable app—with only 13 employees and 30 million users—into a profitable photo sharing service enjoyed by more than 2 billion people, prompting some to brand it, "one of the best business acquisitions in the history of Silicon Valley."[6] Instagram's founders sold their startup to Facebook for a cool $1 billion and are now engaged in other productive tech-related pursuits.[7] Moreover, the rise of TikTok to 1.5 billion users in the time since these acquisitions suggests that competition is alive and well in the apps market.[8]

In each case, the would-be competitor agreed to the purchase; these are voluntary exchanges. Some entrepreneurs will choose to remain independent and compete, while some will opt to sell. Perhaps founders and investors will reinvest their profits in another startup that brings further innovations to consumers. Or perhaps they will choose to sit on a beach. In any case, thwarting mergers by regulation removes the freedom of these entrepreneurs to pursue their preferred path.

M&A activity may also be explained by a lower cost for acquiring a firm than the transaction costs of contracting with an outside firm. Transactions costs include the time and energy of finding someone to meet a specific need, negotiating the terms of the transaction, and enforcing the contract to resolve any disputes.[9] Apart from any considerations of competitive threats, M&A would be a rational decision if the purchasing firm decides that the cost of acquisition will be less than the myriad transaction costs of procuring the solution through priced exchange with an outside entity. That approach could also reduce the total costs, increase efficiency overall, and potentially benefit consumers. Mergers and acquisitions often make economic sense for buyers, sellers, and end users. The cycle of profitability can also produce innovative products and services for consumers.

Go Ask the Horses in the Race. This productive cycle seems to be widely acknowledged and accepted by those working in the tech sector, as entrepreneurs and venture capitalists see acquisitions as profitable exit strategies.

A 2019 survey of startups found that half the respondents thought being acquired was the most realistic long-term goal for their company.[10] Instagram co-founder Kevin Systrom seems to have perceived the consumer benefit of being acquired immediately. He said of his sale to Facebook, "the real question was could we strap our little company onto the side of a rocket ship and get it out to a lot of people really, really quickly."[11]

These acquisitions are so ubiquitous in the real world that an advice website for tech entrepreneurs proclaims, "Startup is outsourced innovation for corporations," before it advises those heading into venture capital pitch meetings to have at least five potential buyers in multiple categories to tell to potential funders.[12] That advice being commonplace is confirmed by entrepreneurs and venture capitalists working in tech today. Rather than seeing a systemic injustice in being acquired, is a is widely accepted business strategy.

The practice of being acquired is so accepted in the mainstream that it's featured in the book, *Venture Capital for Dummies*. The product page for the book notes that because, "IPO's are few and far between today" rather, "Most exits these days involve larger companies acquiring a start-up company to gain a strategic advantage. Big companies often use acquisitions as their R&D departments, and your payoff comes from solving their big problems."[13] Far from a nefarious plot by would-be monopolists twisting their mustaches and looking to destroy competition, larger tech firms are looking to solve problems and keep innovating for customers.

Straight from the Horse's Mouth. The preponderance of economic evidence finds little harm from M&A activity in the tech sector, and recommends a continued liberal allowance of such purchases.

Bain & Company's Technology Report 2021 analyzed all acquisitions of $300 million or more, totaling $150 billion, by Alphabet, Amazon, Apple, Facebook (now Meta), and Microsoft from 2005 to 2020. Through a series of double-blinded case studies, Bain observed if an acquisition benefited consumers with lower prices, increased access to innovations, or improved already existent products or services. The study also evaluated if the acquisition increased competition by pressuring incumbents to innovate or by triggering more external investment. The report concludes that, "most big tech M&A spending actually benefits consumers and doesn't hamper competition."[14]

In a 2017 National Bureau of Economic Research (NBER) study, Gordon M. Phillips of Dartmouth College and Alexei Zhdanov of the University of Lausanne examined the relationship between venture capital activity and mergers and acquisitions globally, across jurisdictions with different levels of regulatory permissiveness. They found "evidence of a strong positive association between VC investments and lagged M&A activity, consistent with the hypothesis that an active M&A market provides viable exit opportunities for VC companies and therefore incentivizes them to engage in more deals."[15] This finding is at odds with the idea of "kill zones," where investment is deterred by M&A activity.

Similarly, in a study published in May 2022, Tiago S. Prado and Johannes M. Bauer of Michigan State University examine the effects of 32,367 venture capital deals and 392 tech startup acquisitions by Google, Amazon, Apple, Facebook, and Microsoft from 2021 to 2020 on venture capital funding to emerging firms.[16] They conclude:

> Overall, we detected evidence of a positive, statistically significant increase in venture investment in the industry segments in which the acquired start-ups operate. During the

> ten-year period covered in our data, there are no detectable, systemic negative effects on start-up funding. Thus, the empirical evidence suggests that, in a given industry segment, venture capital resources available to start-ups for innovation purposes increase after big-tech acquisition.[17]

Axel Gautier and Joe Lamesch of the University of Liège studied 175 acquisitions made by Google, Amazon, Facebook, Amazon, and Microsoft (GAFAM) from 2015 to 2017. They concluded that these firms use acquisitions, for the most part, as a substitute for in-house R&D, since those acquisitions are intended to "strengthen their core market segments but rarely to expand their activities into new ones." They go on to observe that "most of the acquired products are shut down post acquisition, which suggests that GAFAM mainly acquire firm's assets (functionality, technology, talent or IP) to integrate them in to their ecosystem rather than the products and users themselves."[18]

This provides a more nuanced explanation than the "killer acquisition" claim often made by advocates of expanded M&A restrictions. Perhaps the study's most illuminating finding is that when the authors checked for "killer acquisitions," they found only one that qualified out of the 175 transactions. They define the term as an acquisition in the same core business as the buyer, continued operation under the original brand name, and having a substantial user base. While this is a narrower definition of "killer acquisition" than some use, it may be a more accurate and useful one. In any case, the low number of violations is telling.

Policy Makers Should Hold Their Horses. Proposals to lower merger filing thresholds, shift the burden of proof to the parties wishing to merge, or ban mergers above a certain size all come with economic and societal tradeoffs. As Geoffrey A. Manne, Samuel Bowman, and Dirk Auer of the International Center for Law & Economics conclude in a 2022 *Missouri Law Review* article in which they weigh the evidence on the question of tightening merger regulations:

> Critics have so far failed to show that, on balance, mergers harm social welfare – even overlapping ones or mergers between potential competitors—just as they are yet to suggest alternative institutional arrangements that would improve social welfare.[19]

Some critics believe that the unprecedented size and success of the largest tech firms should make them subject to special regulatory attention. These companies, they argue, have become so large and so valuable that antitrust rules need to be amended to address their unique place in markets. But in the U.S., new generations of businesses bring new levels of size, scope, and worth. Today's tech firms represent the latest iteration in a long line of growth and progress. Companies that today seem unprecedented in size and reach will one day be dwarfed by those that comes next.

In a November 2022 NBER paper, Ginger Zhe Jin and Mario Leccese of the University of Maryland and Liad Wagman of the Illinois Institute of Technology compared the M&A activities of the GAFAM companies from 2010 to 2020 to other top acquirers. They found that the "top 25 private equity firms outpaced GAFAM in tech acquisitions per firm since

2018." They also concluded that "technology acquisitions do not shield GAFAM from competition, at least not from other GAFAM members or other firms that acquire in the same categories."[20] Big tech's size is not out of scale in relation to other players in the marketplace, and it does not make GAFAM immune to competition.

To the contrary, tech might be special in a way that recommends *against* regulatory antitrust intervention. In a December 2022 study, Gary Winslett of Middlebury College writes that because technology "changes so quickly, acquisitions—as opposed to organic growth—make a lot of sense," in the tech sector.[21] This special circumstance highlights the wisdom of considering each merger individually and not making blanket prohibitions of what may be beneficial M&A activity.

The speed of innovation and change in tech also makes it more difficult for regulators to predict which mergers will be harmful and which beneficial. No one, not even those employed in government agencies, can predict the future. That is especially true in the fast-changing tech sector.

A more sensible approach to influencing the number of mergers and acquisitions in the tech industry is to remove market-distorting financial regulations, like the Sarbanes-Oxley Act. These restrictions make initial public offerings more expensive, thus increasing the appeal of being acquired to recoup investment or exit profitably instead. Before excessive interventions into markets are made by regulators to suppress M&A, financial regulations that add expense to going public should be eliminated.[22]

Conclusion. There is insufficient evidence of market failure in merger and acquisition activity in the tech sector to justify government intervention. When smaller firms are acquired, there are often collateral benefits. Consumers benefit from the expertise and economies of scale that "Big Tech" can bring to imperfect, obscure, or fledgling products. Government should remove its already present distorting regulations before taking any other action. Making M&A impossible or cost-prohibitive with expanded antitrust regulations or increased litigation may harm the cycle of investment, scaling, innovation, and profitability that has made the United States a global tech leader.[23]

Notes

[1] Ronald H. Coase, Opening Address to the Annual Conference of the International Society of New Institutional Economics, September 17, 1999, https://www.coase.org/coasespeech.htm.
[2] S. 3847 – Prohibiting Anticompetitive Mergers Act of 2022, 117th Congress, Second Session, https://www.congress.gov/bill/117th-congress/senate-bill/3847.
[3] Federal Trade Commission Chair Lina Khan told CNBC: "[S]ome of these kill zones that have been described where, you know, investment dries up, because there's a sense that if you enter, you know, you won't be able to compete on a level playing field. So that's definitely something that we have to be vigilant about to make sure that incumbents are not, you know, engaging in anti-competitive tactics. I think, as I mentioned earlier, I think this is a huge issue, as we see the introduction of some of these next generation platforms, right? As we see voice, cloud, virtual reality, we have to make sure that we're fully learning the lessons of the last two decades . … And applying them in these markets so that we're not allowing the incumbents who just extend and protect their monopolies in ways that are just squashing rivals and engaging in unlawful conduct." "CNBC Transcript: Federal Trade Commission Chair Lina Khan Speaks Exclusively with Andrew Ross Sorkin and Kara Swisher Live from Washington, D.C. Today," CNBC, January 19, 2022,

https://www.cnbc.com/2022/01/19/cnbc-transcript-federal-trade-commission-chair-lina-khan-speaks-exclusively-with-andrew-ross-sorkin-and-kara-swisher-live-from-washington-dc-today.html.

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[9] Coase, Opening Address.

[10] Silicon Valley Bank, *US Startup Outlook 2019: Key Insights from the Silicon Valley Bank Startup Outlook Survey*, https://www.svb.com/globalassets/library/uploadedfiles/content/trends_and_insights/reports/startup_outlook_report/us/svb-suo-us-report-2019.pdf.

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