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Economic Aspects of Mergers and Acquisitions

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Abstract:
The recent liberalization of the earlier state controlled, sluggish Indian economy has made mergers more necessary and acceptable. Till some years ago, takeover of one company by another was viewed in India as a sign of failure of the former, and violent aggression of another.The acquisition was derived mostly by the tax benefits of the loss carry forward. There are now more economic reasons and wider choices of takeovers/mergers.
Competitive forces resulting from globalization and deregulation in many industries across the border have forced most corporate to consolidate.European and Asian markets have become more receptive to merger and amalgamation activity. The merger of Daimler-Benz and Chrysler is a good example of globalization.There was an over –capacity of around 30percent in the global car industry.The merger aimed at helping the functional Chrysler cars to enter the prestigious Daimler Benz vehicles to cruise into the American market, including access to the wide European and Asian network of Daimler-Benz and the help the German car company, on its part to access the logistics and service supporter of Chrysler. With prices falling faster than productivity gains, volume producers in Europe were expected to face a yawning gap of $18 billion between revenues and costs. So a merger to globalize operations made sense.

1. Economic Considerations

1.1. Synergies through Consolidation

The second most important reason for mergers and amalgamations is to realize synergies; either through cheaper production bases as in the case of Jindal Strip's purchase of two units from Bethlehem in US, or by cost savings and pooling of resources in R&D marketing and distribution as in the case of Astra's $36 billion mergers with Zeneca, Hoechst merger with Rhone Poulene or other pharma mergers.
Most M&A take place with the aim to exploit economics of scale, but attaining critical mass and achieving cost-savings. Research has also shown that return on capital goes up as the concentration index rises. This has been proved, especially in the cases of pharmaceuticals industries, pulping and air compressors.
Banking industry too has found global consolidation moves profitable. For the bleeding Deutsche Bank, consolidation of its investment banking activities by acquisition of Bankers Trust paid dividends.
The fact that the size is becoming increasingly important, especially when it takes line of capital involvement, has been one reason for the oil majors to mergers and creates big firms considering the bleak future facing the industry. Companies such as Shelland Exoxon, with international businesses have clearly performed better than those with just domestic focus.
Many a times the merger takes place because of survival instincts and not because of synergies or because one wants to expand. The classical example of this trend is the Malaysia's financial industry. After 8-9 years of wonderful growth and plentiful of money, a regional economic slump fuelled by currency devaluation had bittendeeply into its growth prospects. Mindful of banking and fiancé companies' failure in Thailand and Indonesia –both of which received international financial aid-Malaysia has sought to fortify its domestic companies in a move to rejuvenate the once booming industry.Malaysian Central Bank advised its 40 odd finance companies to merge and consolidate into 5 or 6 core finance companies.Analysts said Bank Negara's activist stance was needed to stir up the finance firms, which with their banking brethren resisted calls to merge while the good times rolled.

1.2. Vertical Integration

One of the common reasons for merging is to sustain growth.Growth could be achieved by increasing market share, gaining access to additional customers {as in the case of telecom and financial sector mergers}. It could also result from better access to distribution and marketing through the partner.A most attractive mode for growth is by getting access to promising foreign markets. It shows that the M&A is a favored route to establisha foothold in foreign markets;to increase market share and also to exploit other country's resources. It could be that the acquired company is in the growth sector, and it seems attractive acquirer.In addition, it may be cheaper to acquirer rather than to build.

AT&T-TCI and Time Warner-Turner mergers are good instances of vertical integration. Stunned by local distributorsAT&T acquired cable operator TCI to link its long distance carrier lines to individual homes and businesses.It could now have access to home and business establishments without the aid of local distributors. Similarly, combining the production unit time Warner with the distribution network of Turner, broadcasting could create vertical integration.

1.3. Customer Demands

The Grand Metropolitan and Guinness merger to create Diageo was to increase the number of product offerings the more such product, the greater the ability to fight retailers with the power to either make or break a brand. In an industry where there are no “must-stock” spirit brands, including a number of in-demand products is the key to greater profitability.Companies can use this consumer pull to negotiate better deals with fewer retailers.

1.4. Technology

The inability to keep pace with technology or to graduate to a higher level of technology was the reason for the better merger of Digital Compaq, and IBM and Lotus Corporation earlier. Compaq’s hold in the lower-end products segment and Digital’s strengths in mini-computers were brought together by the merger. Similarly with the 123 spread sheets getting outsmarted by Microsoft’s Excel, Lotus required a higher technology platform for its SmartSuite program to succeed.The IBM-Lotus Corporation merger aided that process.

1.5. Re-fashioning

Many companies have resorted to the merger and amalgamation route to change their business to high profile business. By acquiring Polygram from Philips, Seagram moved from the low-margin spirits business to the high-margin media segment.After operating as an engineering conglomerate for 111 years, the US-based Westinghouse Electric suddenly transformed itself into a media company. Since 1994, low profitability had forced the company to sell its distribution and control unit, electrical supplies, office furniture business, defense and electronics business, security systems, refrigeration transport and power generation businesses. On the other hand, it acquired among others CBS, Infinity Broadcasting, Nashville Networks, Country Music Television and American Radio Systems to transform itself into just CBS Corporation.

1.6. Increased Market Share

Profitability can be improved by increasing the market share, may be by offering enhanced range products offered.There appears to be a high degree of co-relation between increased market share and increased profitability.This motive is closely aligned to the economies of scale as increasing market share usually leads to higher level of production, thereby lowering unit costs.
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1.7. Tax Considerations

The merging of a sick unit with a healthy unit, brings taxation advantages by allowing losses of the sick company to be set off against the profits of the healthy company. Also, vertical mergers, i.e. with raw material suppliers or downstream units, could also reduce the incidence of sales tax and other levies.However, any merger conceived solely for the purpose of achieving tax advantages is likely to be disallowed.

1.8. Diversification

Merging could also be a strategy to diversify to increase returns or reduce risk. However, there is a school of thought which feels the diversification of companies is of no value to shareholders as they can diversify their own portfolios more cheaply.

2. Strategic Management of Mergers

Any company wishing to embark upon an acquisition or merger programme needs to have clearly defined objectives and an established strategy for pursuing them.Acquisition made on a random or speculative basis are rarely likely to be successful.

2.1. Merger in the Vision and Strategy

The first step of the model is to check whether the merger fits into the vision and strategy of both/all the parties involved:
(a) A typical merger is one where two (or more) parties come together and form a new entity.Neither is taking over or acquiring the other. The horizontal combination of the erstwhile Area, headquartered in Sweden, and Brown Boveri, headquartered in Switzerland, into Asea Brown Boveri (ABB), in the late 1980s is an example.
(b) Even where company A takes over part or whole of company B, the result is a merger.
(c) In either case, i.e. whether coming together, or whether there is a sale and purchase, it is desirable that the top managements of bothA and B have evolved their own respective perspective visions and come to the considered conclusion that a merger is the best strategy. For A, takeover may be a useful strategy for entry into a new product, territory or segment;or a means for faster growth, in addition to internal, organic expansion; or access to resources like capacity, talent, technology, brands or funds. For B, selling out may be a good strategy to divest an unrelated business, focus on businesses, and release resources for such concentration.

2.2. Strategic Search

Once the, in-principle, decision is made to seek a merger the next step is to institute a reasonably thorough search for the right candidate(s):

(a) The strategic planning cells, ifany, at the Group level may be the champions for such search, in the event of an unrelated diversification. For related diversification or expansion, the planning cell of the concerned member company of the group may spearhead the search.

(b) Where necessary, discrete, confidential, external consultancy assistance may be taken.

(c) In addition to the proactive search, be also open to unexpected, sudden offers and opportunities; but evaluate them on the same strategic criteria.

The aim is to achieve optimal, rather than just satisfactory results.

3. Evaluations and Choice

A good search should have scanned and thrown up a reasonable number of alternatives. They need to be evaluated on the basis of some key criteria, so as to arrive at the final choice. The following are some of the important criteria:

(a) How far will the merger candidate contribute to the corporate objectives of profitability/shareholder value, growth/market share, image and long run vitality?

(b) To what extend will it add to the core competence and competitive edge?

(c) To what degree will it add to the resource base, as well as help improve the generation, mobilization and utilization of physical, financial, human, knowledge and other important tangible and intangible resources?

3.1. The Right Price

The above evaluation, hopefully, will throw up a shortlist of about three candidates. Which one is eventually chosen will depend on a combination of its merits and the price at which it can be settled.

3.2. Value to the Acquirer/Partner

The negotiations will need to start from the value of the proposition to the party taking the initiative for the transaction:

(a) In case it is an acquisition, the acquirer will need to simulate and forecast the possible enhanced revenue streams, profits, and earnings per share.

(b) The price will also be influenced by significant assets in the balance sheet, as well as undervalued physical or intangible assets.

(c) It is also worth seeing if the merger will improve the quality of earnings, and, hence, the price-earnings ratio and the market capitalization.

3.3. Value to the Acquire/Partner

The eventual price will naturally, be also influenced by the value to the seller or the responding second party to the merger:

(a) If he is a seller, he will usually try and get the maximum price for it.He can leave it to the acquirer to worry about the strategic fit.

(b) If he is to be a partner in the merged entity, he will need to access the value of staying alone, and the value of merging.The difference is an approximate measure of the value of the merger to him.

(c) He will also need to take into account the undervalued assets, as well as the contingent liabilities of both.

3.4. Harmonizing the Exchange

The right price will need to be negotiated around these two sets of values:

(a) In case of a cooperative, agreed merger, it is better to arrive at a win-win valuation and share exchange, which is far too both sets of shareholders.

(b) In case of an acquisition based on income potential, one needs to be more careful in allowing for economic and competitive uncertainties.

(c) In case of attractive assets, it may be possible to pay closer to the market value.