The differential efficiency theory finance essay

Finance

Merger is combining of two or more independent business corporations into a single entity, usually the absorption of one or more firms by another dominant firm. A merger may be carried out by one firm purchasing the other’s assets with cash or its securities or by purchasing the other’s shares or stock or by issuing its stock to the other firm’s stockholders in exchange for their shares in the acquired firm (thus acquiring the other company’s assets and liabilities). Mergers may be of different types such asHorizontal Merger: if both firms produce the same commodity or service for the same market; market-extensional, if the merged firms produce the same commodity or service for different marketsVertical Merger: if a firm acquires either a supplier or a customer. If the merged business is not related to that of the acquiring firm, the new corporation is called a conglomerate. [Source: Encyclopaedia Britannica]The efficiency theories of merger says that a merger can only occur when it is expected to generate enough realizable synergies to make the deal beneficial to all the parties involved , it is the expectations of gains which results in a amicable merger being proposed and accepted. If there is no gain in value for the target company, it is suggested that the target firm's owners may not sell or submit to the acquisition, and if the gains were negative for the bidding companies owners, then bidder would not complete the deal. Hence, if we observe a merger deal, efficiency theory predicts value creation with positive returns for both the acquirer and the acquired. There are different efficiency theories of mergersDifferential Efficiency TheoryInefficient Management TheoryOperating SynergyPure DiversificationStrategic Realignment to changing environmentUndervaluation

Differential Efficiency Theory

Mergers generally mean combining of two companies into one. According to differential theory of merger, a merger is done where the management of a company A is more efficient than the management of another company B, than it is better if company A acquires the company B and increase the level of the efficiency of the company B. According to this theory if some companie's operating level is below the optimum potential of the company than it is better if it is taken over by another company. This theory also implies that management of a company is also not efficient in running the company and therefore there are always chances that it will be taken over by other companies. It is particularly beneficial when a company decides to take over other company in the same industry because than it would mean that company can expand without spending lot of money by utilizing the resources more efficiently. But there is one risk to this, which is if the acquiring company pays too much for the merger of the companies, but after the merger the resources do not get utilized in a manner which is forecasted than it can lead to problems for acquiring company.

Operating Synergy

Operating synergy theory of mergers is based on the economies of scale that exist in an industry before a merger takes place. The levels of activity at which the firms are operating at are insufficient to exploit the economies of scale thus operating economies of scale are achieved through horizontal, vertical and conglomerate mergers. Operating economies occur due to indivisibilities of resources like equipments, human resources and overhead. The productivity of such resources increases when they are spread over a large number of units of output. For instance, expensive equipment in manufacturing firms should be utilised at optimum levels so that cost per unit of output decreases. Operating economies can be achieved through a merger between firms having competencies in different fields of expertise in different areas. For example when a firm's core competence is in the field of R&D merges with another having a strong competency in the field of marketing strategy, both the businesses would complement each other. Operating economies are also possible in regular management functions like planning and control. According to the theory of Operating Synergy even firms of medium size need a minimum number of corporate staff. The capabilities of corporate staff who are responsible for planning and control are underutilised many times. When such a firm acquires another firm, which has just reached the size where it needs to increase its corporate staff, the acquirer's corporate staff then would be fully utilised after the merger , thus achieving economies of scale. Vertical integration also helps to achieve operating economies by reducing the costs of communication and bargaining.

Pure Diversification

Diversification provides several benefits to managers, other employees and owners of the firm as well as to the firm itself. Moreover, diversification through mergers is commonly preferred to diversification through internal growth, since the firm may lack internal resources or capabilities required. The timing of diversification is an important factor since there may be several firms seeking to diversify through mergers at the same time in a particular industry. Employees: - The employees of a firm develop firm-

specific skills over time, which make them more efficient in their current jobs. These skills are valuable to that firm and job only and not to any other jobs. Employees thus have fewer opportunities to diversify their sources of earning income, unlike shareholders who can diversify their portfolio. Consequently, they seek job security and stability, better opportunities within the firm and higher compensation (promotions). These needs can be fulfilled through diversification, since the employees can be assigned greater responsibilities. Owner-managers: - The owner-manager of a firm is able to retain corporate control over his firm through diversification and simultaneously reduce the risk involved. Firm: - A firm builds up information on its employees over time, which helps it to match employees with jobs within the firm. Managerial teams are thus formed within the firm. This information is not transferred outside and is specific to the firm. When the firm is shut down, these teams are destroyed and value is lost. If the firm diversifies, these teams can be shifted from unproductive activities to productive ones, leading to improved profitability, continuity and growth of the firm. Goodwill: - A firm builds up a reputation over time in its relationships with suppliers, creditors, customers and others, resulting in goodwill. It does this through investments in advertising, employee training, R&D, organizational development and other strategies. Diversification helps in preserving its reputation and goodwill. Financial and tax benefits:
- Diversification through mergers also results in financial synergy and tax benefits. Since diversification reduces risk, it increases the corporate debt capacity and reduces the present value of future tax liability of the firm.

Strategic Realignment to changing environment

It suggests that the firms use the strategy of Mergers and Acquisitions as ways to rapidly adjust to changes in their external environments. When a company has an opportunity of growth available only for a limited period of time slow internal growth may not be sufficientChange in environment which may necessitate Mergers and Acquisitions may include regulatory, tax, technology / Globalization impact etc. E. g. Banking/Insurance/Telecom/ Pharmaceuticals /FMCG/Aviation etcSometimes the firm may have limited period of growth. Adjustment through internal adjustment may take time. So, external acquisition will help to reduce time involved. Otherwise, competitors may exploit the situation

Undervaluation

Undervaluation theory states that mergers occur when the market value of the target firm stock for some reason does not reflect its true or potential value or its value in the hands of alternative management. Firms may be able to acquire assets for expansion more cheaply by buying the stocks of existing firms than by buying or building assets when the target's stock price is below the replacement cost of its assets

Overvaluation

Overvaluation might drive the firm to use its overpriced stocks to acquire other firms. It is however controversial if deals of this type benefit acquiring firms' existing shareholders.