

Benefits behind
mergers and
acquisitions
economics essay



**ASSIGN
BUSTER**

This assignment is going to include a discussion of the theoretical benefits behind mergers and acquisitions, a review of the empirical evidence and also two real world examples, one where value was created and one where it was destroyed.

Theory

The benefits of mergers and acquisitions stem from a concept known as synergy which can be illustrated using a formula, “ $PV_{ab} = PV_a + PV_b + \text{gains}$ ” (Arnold, 2008: 866) also represented as, $2+2= 5$. The theory behind this is that a combined unit would be greater in value than the sum of its parts, basically meaning two firms together are worth more than the value of the firms if they were apart. One benefit of this is the increase in market power which is a firm’s ability to exercise a degree of control over the price of a product. This can be achieved in more than one way but for example if a firm merged with another and then found itself in a monopoly position it would have the ability to push up the price of its products because consumers would have fewer alternative suppliers. Another advantage is the increase in economies of scale achievable. In most cases the larger the size of a firm the lower the cost per unit of output because of cost advantages being better exploited. For example if two firms in the same industry merged they could gain marketing economies of scale through joint advertising perhaps and also administration economies by sharing administrative activities and accounting. There would also be financial economies as funds borrowed on the capital market would be provided at lower costs and with more favourable rates of borrowing. Internalisation of transactions is also a benefit; if two firms at different stages of the production chain merged, a

<https://assignbuster.com/benefits-behind-mergers-and-acquisitions-economics-essay/>

greater efficiency of co-ordination of the different levels may be the outcome. This could be achieved because of reductions in costs such as communication, monitoring, contract enforcement and bargaining. Usually entering in to a new market or industry takes years of effort and during the early period losses may even be incurred, however through the process of mergers and acquisitions this once daunting task can become much easier. By acquiring an existing firm that already possesses the required skills and market strength it eliminates the need for them to be generated internally. There are also tax advantages of acquisitions in some countries because losses of subsidiaries can be used to offset present taxable profits of the parent company meaning a lower tax bill. Therefore acquiring firms which have accumulated tax losses may be beneficial; however this benefit is not present in the UK due to much stricter rules being in place. Another benefit of mergers and acquisitions would be risk diversification. A firm may be viewed as less volatile if its cash flows come from a wider range of sources meaning shareholders gain from a reduction in risk but with no decrease in return. The greater stability of earnings may also be appealing to lenders which could result in lower interest rates.

Mergers and acquisitions are usually used as an instrument to create shareholder value (Sudarsanam 2003), this is the main objective; however there also seem to be managerial motives present. When a firm acquires another it consequently becomes a larger enterprise meaning managers have more responsibility and so may be justified to receive a much larger salary. Some may feel more successful and important because of this and this sense of achievement may become a personal driver for managers to

carry out mergers and acquisitions. Another reason could be survival, the management team may begin to feel the best way to avoid being taken over or dominated is to grow themselves, especially if regular mergers are occurring in the industry the firm operates in. This could lead to firms not merging for just the benefit of shareholders but also to try and assure the survival of the management team.

A question one may wish to ask is how the value of the benefits of mergers and acquisitions can be measured? The benefits of acquisitions are usually not easy or straightforward to put in to numerical form. For example the application of superior managerial skills or entry in to a new market cannot accurately be measured; even things such as competitive position and reputation with customers, the list goes on. These items will not be found on balance sheets so therefore the true value of a firm may not be presented; however one indicator which could perhaps value the benefit may be the firms share price.

Empirical evidence

Although the theory behind mergers and acquisitions suggest that they create value for both the shareholders of the offeror and offeree companies the empirical evidence doesn't always seem to support this. (Meeks 1977) conducted a statistical test to represent the effects of mergers, he took profits from the merged companies after the merger and compared them with the weighted average of the participants profits had they not merged based on their earnings prior to the merger. His conclusion was that merged profits were less than those that the participants would have received had

they not joined forces. However some have questioned Meeks research “ There are weaknesses in Meeks’s work” (Ulen, 1980: 234). This being said Alan Gregory’s review of the long run performance of UK acquiring firms reached a similar conclusion “ the long-run shareholder wealth effects of recent acquisitions in the UK have been, on average, significantly negative” (Gregory, 1997: 984). However a study to evaluate takeovers in the UK from 1955-1985 suggest that both offeror and offeree company shareholders gain from mergers “ we find that mergers have, on average, been value-creating for shareholders as measured by equity market prices around the merger announcement date. Shareholders of targets gain, and bidder shareholders gain or do not lose.” (Franks and Harris, 1989: 247). Empirical evidence of the overall wealth gains of target shareholders from stock mergers were reviewed by (Loughran and Vijh 1997). They found that target shareholders that sold out soon after the acquisition date gain from all acquisitions; however those who held on to the acquirer’s stock find their gains diminish over time. Studies on post merger performance of acquiring firms seem to generally forecast negative results as can be seen here “ We find that stockholders of the acquiring firms suffer a statistically significant wealth loss of about 10% over the five years following the merger completion.” (Agrawal, Jaffe & Mandelker 1992: 1618) and also here “ We find that these takeovers have a positive but not always significant impact on profitability, and a negative impact on short and long run returns” (Cosh, guest and Hughes 2005: 489).

Real world examples

In 2006 Disney bought Pixar for \$7.4 billion. The two companies had been working together prior to the merger but with two different sets of shareholders there were barriers that existed, however with the merger the two companies became able to collaborate freely and with ease. Pixar has doubled its yearly film output something that would have been unthinkable before the merger and with expert advice from Disney has improved vastly in fields such as advertising and merchandising. “Pixar movies tend to perform better than animated movies developed by Disney itself” (Garrahan, 2010: 16), “Toy Story 3 is on course to become the biggest grossing animated film ever released by Walt Disney after generating \$630.2m in its first month in cinemas” (Garrahan, 2010: 16).

In 1994 BMW acquired Rover for £800 million. Only six years later and after millions of pounds worth of investment they sold the company, “The brand had declined too far to be rescued. The German group ploughed {XEU} 4bn into its “English patient” before getting out in 2000.” (The financial times, 2005) The company was sold to the phoenix four for £10! “Who bought Rover from BMW for [pounds sterling] 10” (Eaglesham & Peel, 2008: 5). This was a huge disaster, some blamed it on communication “When BMW bought the Rover business, communication with the German managers was even worse (exacerbated by political infighting on the German side). Failure was the inevitable and bitter result.” (Lester, 2007: 8) and others on the fact that Rover may have been a lost cause to begin with “” Even the mighty BMW, which bought Rover in 1994, had to accept in the end that the brand had declined too far – or at least to give it a future would cost far too much money.” (The financial times, 2005)

Conclusion

To conclude having researched for example Meek's and Gregory's financial analysis of the empirical evidence and reviewing the real world examples discussed above one may argue that mergers and acquisitions on average may not be beneficial to the shareholders of the acquiring firms.

Management tends to underestimate the level of organisation required and therefore take off more than they can chew. However as seen in the Disney-Pixar case mergers can benefit both the offeror and offeree at times.

Wordcount: 1492