Corporate financial management

Finance

When on the topic of mergers, many people, for various reasons differentiate between the terms merger, acquisition and take-over. In this essay I will use the terms interchangeably, as most commentators do, because in reality many combinations of companies do not fall into such neat categories, and to many the distinction is debatable. I will work round Glen Arnold's definition of a merger as the " combining of two business entities under common ownership" (Corporate Financial Management, P. 869) Economists classify mergers into three categories - horizontal, vertical and conglomerate.

If the merger takes place between firms which serve the same markets, and produce similar, or substitutable products or services, e. g. banks, then it is deemed to be a horizontal merger. One of the motives for horizontal mergers would be the opportunity to reduce joint costs of production, distribution and marketing. And because some horizontal mergers occur for the enhancement of market power from the reduction of competition, they often attract the attention of the Office of Fair Trading and the UK Competition Commission.

The second type of merger is vertical. This is when business units engaged in complementary stages of a production or service process combine, e. g. breweries with pubs. As with horizontal mergers, there are; production, distribution and marketing benefits, as well as the increased certainty of supply or market outlet. And finally, a conglomerate merger is the coming together of firms which operate in unrelated business areas, such as properties with hosiery. Forces motivating their growth appear to be mainly those of risk diversification.

With other motives including the opportunity for improved efficiency and cost reduction, and, in some cases, the power ambitions or desire for security of their leading shareholder or directors. Firms decide to merge for a variety of reasons, but the primary motive for most is the underlying idea that the combined entity will have a value greater than the sum of its parts. This is the concept known as synergy, which can come about only if the total operations net cash flow after the merger is enhanced.

This gain in cash flow maybe the result of a number of synergistic benefits including economies to scale and increased market power, both of which I will go into more detail later. Firstly, I will talk a little about the concept of synergy. If two firms, A and B merged, and the discounted cash flows of the merged firm were i?? 100m, but the discounted cash flow for A and B alone were 50m and 30m respectively, the gain resulting from the merger is 20m. But who is likely to receive this extra value?

If a lone bidder with one of several possible targets can achieve the synergistic gains, then competition arguments suggest that most of the gains should end up with the acquirer's shareholders. But in a situation with a single target and several possible bidders, where the acquiring firm is likely to have to pay a price significantly above the pre-bid value to gain control, then competition considerations imply that most that the majority of the synergistic gains will go to the target firms shareholders.

Although theoretically, a merger should always be for the mutual benefit of both sets of shareholders, a UK study by Limmack (1991) has shown that there were wealth increases to shareholders in victim firms and wealth

decreases to shareholders of bidder firms in the period from 1977 to 1986. An important contributor to synergy is the exploitation of economies of scale. A horizontally merged firm has possibilities for longer production runs and lower total set up costs and vertical integrations can remove uncertainties of supply between production stages by more closely integrating production stages or by lowering transportation costs.

This was the case in the oil industry following a number of mergers around the turn of the millennium, such as Exxon and Mobil, and also Chevron and Texaco. But all three types of merged firms have the potential for reducing costs through the sharing of central services such as administrative activities, marketing, legal departments and accounting. Financial economies, such as the ability to raise funds more cheaply in bulk, are also possible, as is the development of staff because a larger firm might have a better structured training programme and access to a wider range of knowledge and experienced colleagues.