Mergers

Definitions

Merger (or acquisition or takeover):

Two independent companies join together to form a single company. It may involve the exchange of shares in the two independent companies for shares in the new company (not necessarily involving any financial transaction). Or the acquiring company may decide to purchase some or all of the shares of the acquired company.

There are three types of mergers:

A. **Horizontal integration**: between firms producing the same product/service. Attention of the competition authorities since competition is reduced.
B. **Vertical integration**: between firms operating at different stages of the same production process.
C. **Conglomerate merger**: between firms producing different goods.

Horizontal mergers: motives

1) To <u>increase market power</u>, especially when collusion is difficult to organize or control. A reduction in the number of competitors may also facilitate collusion among the remaining firms.

   A merger can also be a solution to protect the incumbent from an entrant (acquiring it might be cheaper and less risky).

   How much the market power increases after a merger depends upon:

   a) Degree of seller concentration
   b) Productive capacity of rivals
   c) Ease of entry
   d) Market demand
   e) Level of buyer concentration
   f) Acquisition of a failing firm

Horizontal mergers: motives

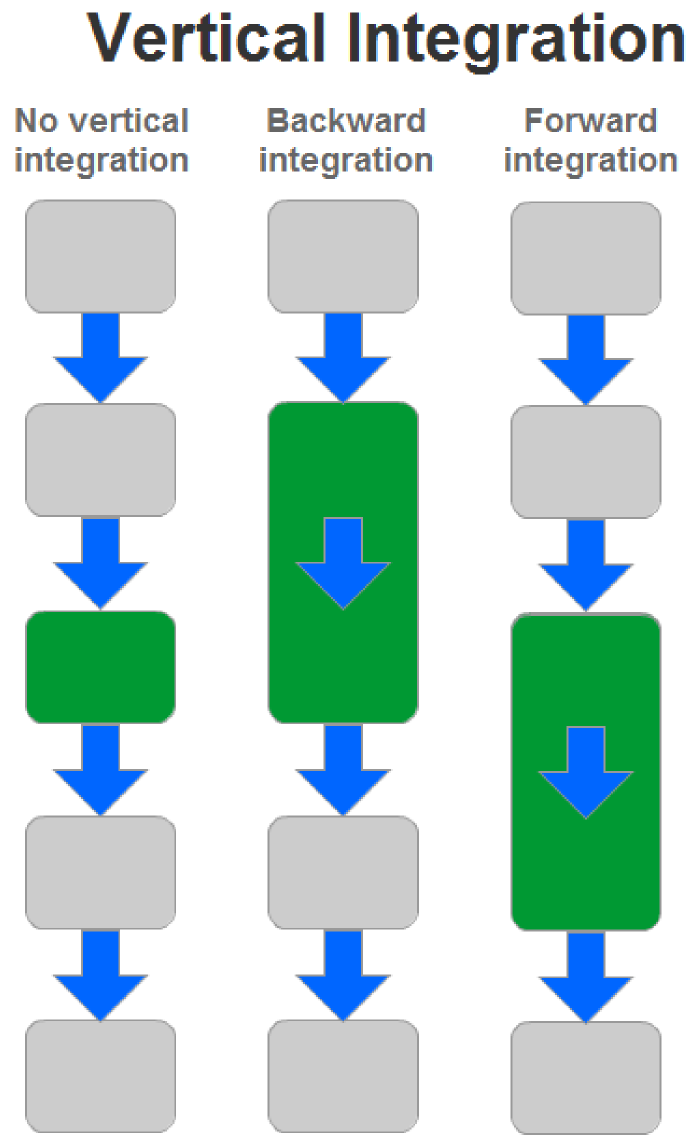
2) To <u>save costs</u> through:
   a) Rationalisation;
   b) Economies of scale;
   c) R&D cost reductions: elimination of duplication of efforts, knowledge integration, improved diffusion;
   d) Purchasing economies because of increased bargaining power;
   e) X-inefficiencies and organizational slack;
   f) Better coordination of joint operations;
   g) Sharing of complementary skills (ex. excellence in production of the first and excellence in distribution of the second):
   h) Better interoperability (ex. former incompatible software jointly developed after the merger);
   i) Network configuration.

Horizontal mergers: motives

3) To reach managerial aims: in some cases, growth is a performance indicator for managers, who for this reason might be more willing to merge with other firms;
4) To remove underperforming managers. Risk: winner's curse;
5) To avoid bankruptcy;
6) To allocate capital within the organization and not on capital markets.

Vertical integration

- **Upstream** (backward) vertical integration: to gain control over a supplier;
- **Downstream** (forward) vertical integration: to gain control over a customer.



Vertical integration: motives

1) To **increase market power**:

   a) Double mark-up: ex. production is under monopoly control of a single producer and distribution is under monopoly control of a single distributor. Both add their own mark-ups ending in a price that is higher and an output that is lower than it would be in case the two stages were vertically integrated;

   b) Forward: to acquire an inefficient seller (reducing market costs or stock levels): **Adelman-Spengler hypothesis**;

   c) Backward: to acquire an inefficient supplier or the supplier of a crucial component;

   d) To facilitate price discrimination, for example by preventing reselling from high-elasticity sectors to low-elasticity ones.

Vertical integration: motives

2) To **save costs**:

a) To reduce transaction costs: with closely related or technologically complementary production processes, vertical integration could allow better planning and coordination, longer production runs and better use of capacity;

b) Uncertainty: (1) an integrated firm might gather information more easily; (2) an integrated firm produces goods for its own consumption, avoiding making publicly observable market transactions and creating therefore uncertainty in the minds of rivals; (3) an integrated firm better controls the quality of inputs;

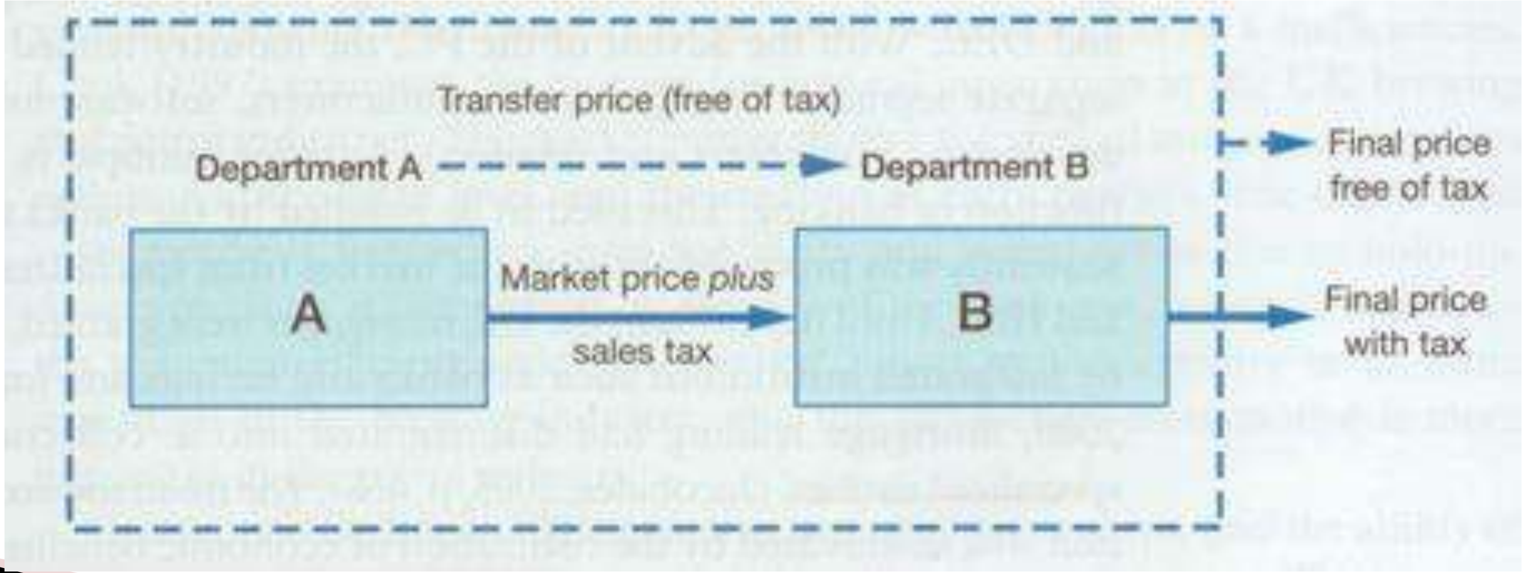
c) Assured supply of technologically complex or strategically relevant components (caution in case of shortage caused by factors beyond the supplier's control);

d) Externalities;

e) Complexity: with a non standard product, for example because of frequent changes, it may be difficult to specify all the possible circumstances in a contract. It may be simpler to vertically integrate.

Vertical integration: motives

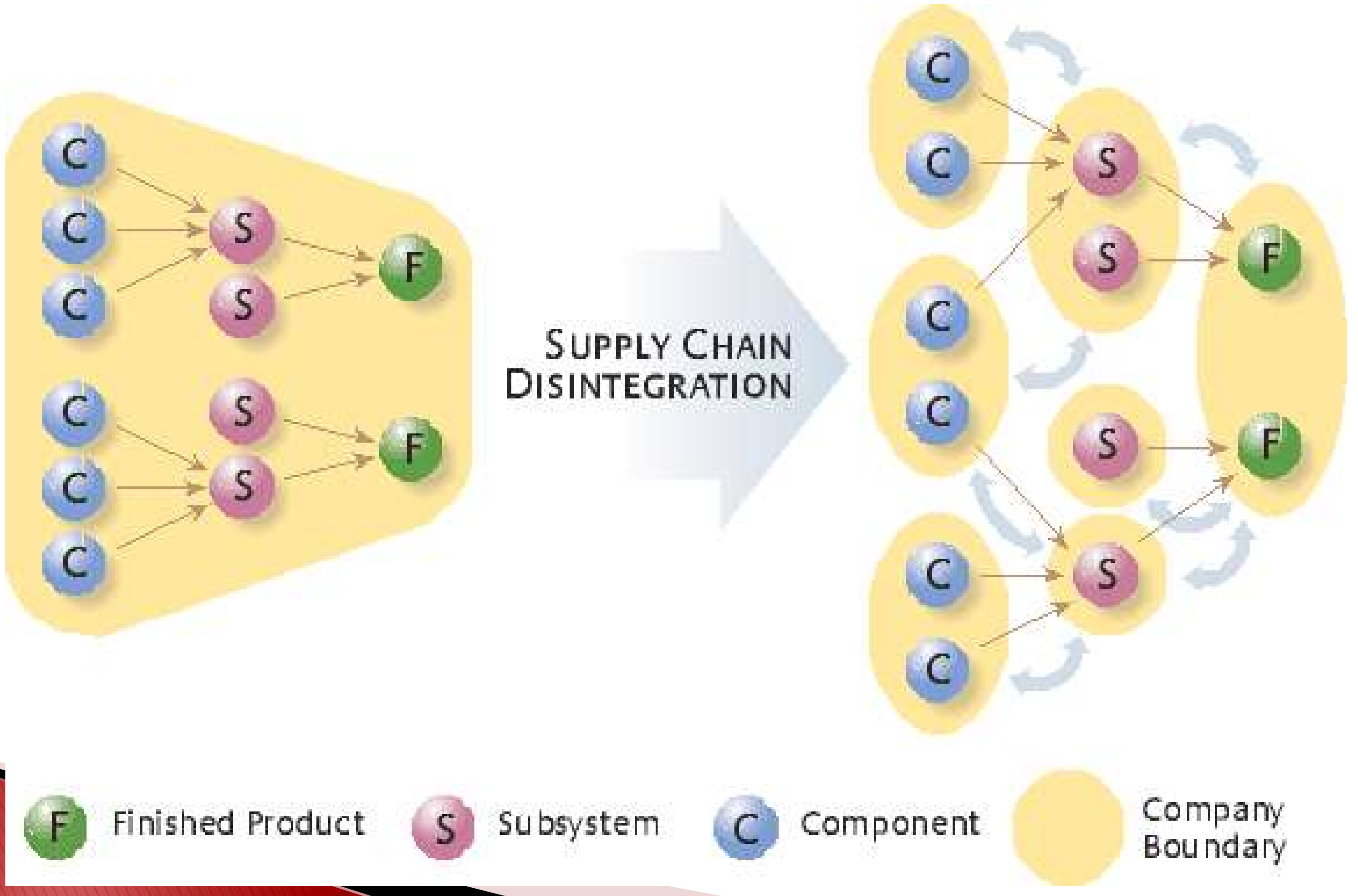
2) To save costs (cont.):
   f) <u>Moral hazard reduction</u>: this could be reached also by monitoring the supplier's work, but it is sometimes too expensive;
   g) Reduction of <u>asset specificity</u> problems, which occur when two firms are dependant on each other because of investments in specific physical capital, human capital, sites or brands;
   h) <u>Avoidance of taxes</u>:



B. Vertical integration

Vertical disintegration

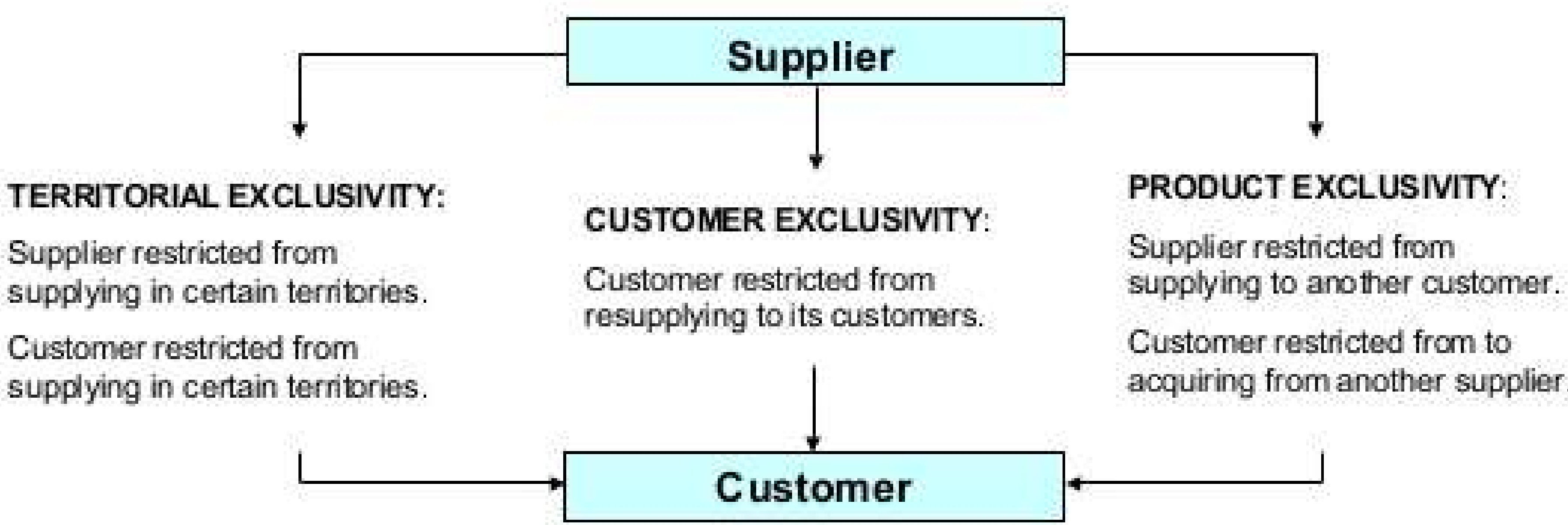
In some cases firms might want to disengage from parts of the supply chain and to transform themselves into smaller and more specialized organizations.



Alternatives to vertical integration: vertical restraints

Definition: conditions and restrictions on trade imposed by firms that are linked vertically. In other words, they are long term contracts among firms in different stages of the production process specifying prices or other conditions/behaviours.

The **aim** is to control externalities involving firms at different stages of the production process (and where vertical integration is too costly). Not necessarily negative for the economic welfare.



Motives for vertical restraints

1) **Enhancement of market power.** The market power that one firm has over one stage of production/distribution can be extended to an adjacent stage by means of VR.

2) **Cost savings.** An externality problem occurs if retailer A is available to invest in a large retail space, where customers can see all products and be advised by fully trained staff and retailer B can gain by offering no pre-sale service and undercut prices, attracting customers who have already gathered information on the product by freely accessing the pre-sales service of retailer A.

   A <u>solution</u> could be that the producer refuses to supply retailer B, or adopts a policy of resale price maintenance.

   The EU recommends **three tests** to check if free riding is a valid problem to impose vertical restraints:

   (a) it should relate to pre-sales;

   (b) the product should be new or technically complex;

   (c) the product should be relatively expensive.

Forms of vertical restraints

1. **Resale price maintenance (RPM):** an upstream firm keeps the right to control the price at which its product is sold by a downstream firm, typically a retailer. Usually it is a minimum price, but it is possible to have maximum prices.

   It has been <u>criticised</u> for several reasons: (a) contrary to the principle of alienation; (however the owner of a good has the right to offer any contract associated with the sale of its good); (b) anticompetitive (it can protect the retailer cartel from entries by other retailers available to offer price discounts); (c) it artificially increases prices; (d) RPM enables an easy profit margin in domestic markets, helping inefficient manufacturers stay in business while losing the market incentive to cut costs and become more efficient.

   But there are also <u>pros</u>: (a) it allows cost savings in distribution, it helps retailers to be more profitable and therefore fosters retailers to provide the necessary pre-sale service; (b) it prevents price wars, protecting small retailers who cannot buy in bulk; (c) consumers do not have to waste time searching for the best deal.

Forms of vertical restraints

2. **Foreclosure:** refusal to supply a downstream firm (with an essential good or service it produces), or to purchase from an upstream firm. Complete foreclosure occurs, for example, when a supplier controls all of the downstream outlets: non-integrated rivals are denied a share in the relevant market.

   It can be partial (excluding only some rivals) or complete.

   Foreclosure can be achieved by means of very high prices or of incompatibility with the technologies of the users.

   To check if foreclosure is harming competition, there are three main questions:

   1. is the ability to compete of excluded rivals reduced?

   2. is market power increased by exclusion?

   3. Is exclusion profitable?

Forms of vertical restraints

3. **Territorial exclusivity:** producers may allow dealers to operate only in specific locations. In some cases the dealer can operate only in a particular territory but can serve any customer. In other cases, the dealer may be obliged to serve only customers from a specific location.
4. **Slotting allowances**: large buyers require fees from suppliers to place their products in prominent positions.
5. **Quantity-dependent pricing**: the price per unit paid by a buyer depends on the quantity purchased:
   a) <u>Quantity forcing</u>: a buyer is obliged to buy more than he would wish (it could force the buyer to decrease prices in order to sell the huge quantity, with a possible positive effect on the final customer, helping solve the double marginalization problem);
   b) <u>Non-linear pricing</u>: a buyer pays a fixed fee, plus a price per unit. As the bought quantity increases, the average cost per unit falls;
   c) <u>Bundling</u>: several goods offered as a single package, whether they are used or not (ex. room with gym and swimming pool). It can be used as a form of price discrimination or as a barrier to entry (monopolist on two bundled markets makes it more difficult to entry);
   d) <u>Tying</u>: the selling of one good is conditional on the purchase of another.

Tying helps to:

- Avoid price controls: if the price on one product is controlled, by selling it together with another one firms can avoid the control;
- Protect quality: if maintenance is essential to maintain the quality of the product, the producer might want to do it by himself;
- Exploit economies of distribution: especially in the case of assembled products;
- Discriminate prices: ex. colour printers and ink cartridges: large customers, using more ink, end to paying more, even if the price of the cartridge is the same;
- Extend the monopolistic market on tied markets.

Vertical restraints: good or bad?

Before the Chicago School:

They are bad because they decrease the independence of distributors.

Since 1970s

Vertical restraints are analysed case by case and are not necessarily bad. In some cases they can, for example, help promote a supplier brand.

Conglomerate mergers (diversification)

Types of diversification:

1. **Product extension**: the new product is related to the existing one;
2. **Market extension**: new geographic markets;
3. **Pure diversification**: movements into unrelated business fields. It is relatively unusual. Sometimes it appears as pure diversification but it is, in reality, something different.

Diversification can be developed → Internally

Diversification can be developed → Through M&A

Motives for diversification

1) Market power enhancement:
   a) **Cross-subsidisation and predatory competition**: a diversified firm can obtain resources from one activity to fight competitors in other sectors (ex. covering the costs of predatory pricing);
   b) **Reciprocity**: firm A purchases inputs from firm B on conditions that also firm B purchases from firm A (a diversified firm is in a stronger position)
2) Cost savings
   a) **Economies of scope**: cost savings achieved by joint production of different products.
   b) **Reduction of risk and uncertainty**, especially for very uncertain markets.
   c) **Reduction of tax exposure**: profits in one activity can be used to counterbalance losses in another.

Motives for diversification

3) Reduction of transaction costs
   a) **Internal capital market**, with better access to information and better ability to monitor performance than an external funder
   b) **Internal assets and resources** that it is possible to use in other markets. These resources can also be sold to these other markets, except when:
      - The asset is not patentable (ex. tacit knowledge)
      - The asset may be too difficult to transfer (ex. an R&D team)
      - Transactions costs may be too high (ex. with complex technology)
      - Externalities (ex. B buys A's brand, but if B cannot maintain A's quality standards, A's reputation may suffer)
4) Managerial motives: managers might want to diversify to grow faster, or to reduce the risk of failure, regardless of what is the best choice for the company;
5) Foreign competition: it might force firms to become more competitive by exploiting new capabilities at the global level.

Mergers: some specifications

An acquisition starts when the buyer's managers launch a **takeover bid** to stakeholders of the target firms (promise to buy shares of the target company at a specified price for a specific period of time). The hope is to acquire the control of the target company (offered prices are higher than those on the stock market).

It is **hostile** when the managers of the target firm do not want to be acquired.

Often this type of operations originates specific costs mainly linked to **conflicts** between different company cultures or because of an unfair behaviour of the buyer, who does not comply with the promises made to the acquired firm's managers.

Takeover bid: an example

DOCUMENTO DI OFFERTA

OFFERTA PUBBLICA DI ACQUISTO VOLONTARIA PARZIALE

AI SENSI DEGLI ARTICOLI 102 E SEGUENTI DEL DECRETO LEGISLATIVO N.58 DEL 24 FEBBRAIO 1998

AVENTE AD OGGETTO AZIONI ORDINARIE

META S.P.A.

OFFERENTE

HERA S.P.A.

STRUMENTI FINANZIARI OGGETTO DELL'OFFERTA

N. 49.967.773 AZIONI ORDINARIE META S.P.A.

CORRISPETTIVO PER AZIONE

EURO 2,825

PERIODO DI ADESIONE

DALLE ORE 8,30 DEL 31 OTTOBRE 2005 ALLE ORE 17,40 DEL 22 NOVEMBRE 2005, ESTREMI INCLUSI, SALVO PROROGA COME CONCORDATO CON BORSA ITALIANA S.P.A.

CONSULENTI FINANZIARI DELL'OFFERENTE

Banca IMI S.p.A. – Gruppo SAN PAOLO IMI

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Hostile takeover: counter-measures of the target firm

The target firm can adopt strategies (decided by shareholders with at least 30% of favourable votes) in order to avoid the takeover:

1. **Greenmail defense**: the target company buys a certain amount of its own shares at a very high price with bonus (illegal in some countries);
2. Search for a **white knight**: a friendlier firm available to buy a controlling interest before the hostile bidder. Typically, the white knight agrees to pay more than the acquirer's offer to buy the target company's stock, or it agrees to restructure the target company after the acquisition is completed in a manner supported by the target company's management. Ex. FIAT's takeover of Chrysler in 2009 to avoid its liquidation;
3. **Poisoned pills**: the targeted company dilutes its shares so that the hostile bidder cannot obtain a controlling share without incurring in massive expenses;
4. **Pacman defence**: Buyout of shares of attacking company in order to take control over it;
5. Request for the attention of media or of the **anti-trust authorities**;
6. **Staggered board**: Extension of the mandate of the Board of Directors.

If desperate, the threatened board may sell off key assets and reduce operations, hoping to make the company less attractive to the bidder.

Hostile takeover: an example

- In 1997 Krupp-Hoesch announces its intention to take over Thyssen (bigger and more profitable), with the positive opinion of analysts and financial experts and with the support of large German banks;
- Shares of Thyssen were dispersed, making it easier for Krupp to reach a majority;
- Conflicts between the two companies increased, with an increasing number of people protesting publicly (mainly employees afraid of loosing their job - in 1997 more than 4.7 m. people were unemployed);
- Protesters closed their account in the banks supporting the takeover and politicians started to get involved, due to the possible impact on unemployment;
- Krupp withdraw its offer in September 1997, but it started a dialogue with Thyssen, with a partial merger of the metallurgical sections, which later led to the merger of the whole companies, at the beginning of 1998.
- The reduction of workforce was minimal. Only problem was the choice of the leader of the new company.

Hostile takeover: an example

- In 1986 Revlon, already owning 9.2 b. shares of Gillette, decided to buy the rest of the company, offering 65$ for each share (against a current price of 58.25).
- The two companies started a negotiation and Revlon agreed to sell its shares to Gillette for 558b. $ (price: 60.65$), with a profit for Revlon of 43 m. $. Revlon also signed an agreement stating the prohibition for Revlon (an any of its companies, including its representing bank) of buying out Gillette's shares without the consent of its board for three years.
- In order to avoid future hostile takeover attempts, Gillette:
  - Reduced costs and sold less profitable enterprises, increasing efficiency;
  - Staggered board was introduced, able to maintain the control also after an hostile takeover;
  - Signed secret (and secretly paid) agreements with other 10 companies.
- Being effectively protected against the danger of hostile takeovers, the company grew constantly until 2005, when it was bought by P&G.

Source: Puziack and Martyniuk, Defensive strategies against hostile takeovers. The Analysis of selected case studies, in «Journal of International Studies», 2012, Vol. 5, n. 1, pp. 60-69.

The effects of changes in firms' control

- Mergers and acquisitions are sometimes due to **technological changes**, which cause an increase in the minimum efficient scale in several industrial sectors, and therefore push companies towards an increase in their productive capacity;
- In theory, after an acquisition the managers of the buyer firms are supposed to be able to better manage the target company, for example by obtaining new funding or by ensuring access to new markets. If this is true, the value of the target firm after the acquisition should increase, as well as the value of the buyer.
- In reality, after the announcement of a takeover, the share value of the target firm increases while the value of the buyer decreases.

WHY?

The failure of mergers and acquisitions

Only 30% of M&A have created value for shareholders.

Why?

1. Excessive costs;
2. Failed targets;
3. Difficult integration;
4. Incomplete evaluations;
5. Rivals reactions.

Summary

- Mergers: definition
- Horizontal mergers
- Vertical integration and vertical disintegration
  - Vertical restraints
- Conglomerate mergers
- Takeover bids and mergers consequences

Reading list

- Chapt. 18 (exc. 18.4, 18.5, 18.6); chapt. 19 (exc. 19.5, 19.6); chapt. 20, chapt. 22 (exc. 22.5) , Lipczynski et al., 2013