# TOPIC 2: MERGERS, ACQUISITIONS AND THE MARKET FOR CORPORATE CONTROL

THE MARKET FOR CORPORATE CONTROL

The market for corporate control refers to the mechanism by which firms are matched up with management and owners who can make the most of the firm’s resources (Brealey & Myers, 2007). It is the market in which investors/ management teams buy/ sell corporations and compete for control of a company (Kaen, 2003). Because of the prevalent separation of management from control in most corporations, agency conflicts may arise, where the managers do not act in the best interest of shareholders (the owners). Agency costs (monitoring costs, bonding costs, and residual loss) have to be borne to align the interests of the managers and owners. Usually, the board of director’s acts on behalf of the shareholders to ensure the firm is run in the best way possible so that shareholders get maximum returns- and most take their roles seriously.

The market for corporate control represents an important governance device. For market-based economies, the disciplinary role of control changes is well. To a large extent, this market is based on hostile takeovers, and proxy contests (Koke, 2004). The board of directors has to ensure that it delivers value to shareholders else they face eviction, or at worst the company may be taken over by new owners. This enhances discipline in the running of corporations and helps to align the objectives of the managers and shareholders. The market for corporate control also includes creditors who also face an agency conflict with shareholders. When potential creditors lend money to an organization, there is the possibility that managers invest such money in unintended projects, making poor returns and thus increasing the likelihood of default. Consequently, creditors have every incentive to monitor the actions of management.

Questions about the market for corporate control include; what ensures that the board has engaged the most talented managers? What happens if managers are inadequate? What if the board of directors is derelict in monitoring the performance of managers? Or what if the firm’s managers are fine, but resources of the firm could be used more efficiently by merging with another firm? Can we count on managers to pursue arrangements that would put them out of jobs? (Brealey & Myers, 2007). If the firm is not being run optimally, there are ways to change the management or ownership.

* A successful **proxy contest** in which a group of stockholders votes in a new group of directors, who then pick a new management team;
* The purchase of one firm by another in a **merger or acquisition**;
* A **leveraged buyout (LBO)** of the firm by a private group of investors; and
* A **divestiture**, in which a firm either sells part of its operations to another company or spins it off as an independent firm.

We examine each of the ways in turn, starting with mergers/ acquisitions.

MERGERS/ ACQUISITIONS

When two firms combine to form one company, we say that they have merged. This may be voluntary, or a case where one firm acquires another (acquisition) - in which case one firm is a protagonist and the other is the target. During periods of intense merger activities, the management spends a significant amount of time either searching for firms to acquire or worrying about whether some other firm will acquire their company. Note that a merger adds value only if the two companies are worth more together than apart, that is there is synergy.

WHY DO COMPANIES MERGE; THE MOTIVES

Many theories have been offered to explain why mergers and acquisitions (M&As) occur. Efficiency theories suggest that mergers occur to exploit economies of scale or synergies. Market power theories argue that consolidation creates oligopoly benefits. Agency theories suggest that mergers and acquisitions may solve agency problems by acting as a mechanism to remove ineffective managers or, alternatively, that mergers and acquisitions may be a manifestation of agency problems with managers making unwise acquisitions as a result of hubris or empire-building motives. Benefits from diversification or tax considerations have also been suggested as a motive for M&A activity. Although no single cohesive theory of mergers and acquisition has been developed, most of these theories have received at least some empirical support (Neuhauser, 2010).

The motives for mergers may be divided into two: the sensible motives (that are known to add value) and the dubious motive (that at best add no value and at worst are value destroying). It is also important to distinguish between the different types of mergers. Horizontal mergers take place between two firms in the same line of business, say EABL and Keroche. A vertical merger involves companies that are at different stages of production. The buyer expands back toward the source of raw materials (by for example, Keroche or EABL acquiring a large scale barley growing company) or forward in the direction of the ultimate consumer (for example by acquiring a retailer or distributor of their products). Note that for both vertical and horizontal mergers, the companies are in the same or very closely related lines of business. A conglomerate merger involves companies in unrelated lines of businesses; take for example, Safaricom LTD acquiring Oserian- the floriculture company at Naivasha.

Note that even for mergers that seem to make sense, they still may ultimately fail (as research shows they have done) because of the complexity in integrating two firms with different production processes, accounting methods, and corporate cultures.

**SENSIBLE MOTIVES FOR MERGERS**

1. ECONOMIES OF SCALE

Just as most of us believe that we would be happier if only we were a little richer, so every manager seems to believe that his or her firm would be more competitive if only it were just a little bigger. Achieving economies of scale is the natural goal of horizontal mergers. But such economies have been claimed in conglomerate mergers, too. The architects of these mergers have pointed to the economies that come from sharing central services such as office management and accounting, financial control, executive development, and top-level management (Brealey & Myers, 2007).

It is possible for managers to justify a merger based on economies of scale. It is worth noting that economies of scale and diseconomies of scale are two sides of the same coin. Thus corporations should be careful not to take their quest for economies of scale too far.

1. ECONOMIES OF VERTICAL INTEGRATION

In a bid to gain control over the production process, companies may expand backward to the output of the raw materials or forward to the ultimate consumer. Thus a firm may merge with a supplier or with a customer. This facilitates coordination and administration.

1. COMPLEMENTARY RESOURCES

Many small firms are acquired by large ones that can provide the missing ingredients necessary for the small firms’ success. The small firm may have a unique product but lack the engineering and sales organization required to produce and market it on a large scale. The firm could develop engineering and sales talent from scratch, but it may be quicker and cheaper to merge with a firm that already has ample talent. The two firms have complementary resources—each has what the other needs—and so it may make sense for them to merge. The two firms are worth more together than apart because each acquires something it does not have and gets it cheaper than it would by acting on its own. Also, the merger may open up opportunities that neither firm would pursue otherwise.

A good example of this has been the acquisition by Facebook® of Instagram®,[[1]](#footnote-1) a mobile photo sharing site for US$ 1 Billion (cash and stock) in April 2012. The acquisition enabled Facebook to own critical photo sharing technology that would have probably taken years to develop independently or be forced to pay royalties to Instagram for the use of the technology. The acquisition in this case would make sense. This acquisition was also seen by analysts as a move by Facebook to end a potential threat to its dominance in photo sharing. What is your opinion on using acquisition as a strategy to deal with a potential competitor? As we mentioned earlier, there are many motives for mergers/ acquisitions- and Facebook may have taught us just another motive- to deal with potential competitors.

1. SURPLUS FUNDS

Suppose that your firm is in a mature industry. It is generating a substantial amount of cash, but it has few profitable investment opportunities. Ideally such a firm should distribute the surplus cash to shareholders by increasing its dividend payment or repurchasing stock. Unfortunately, energetic managers are often reluctant to adopt a policy of shrinking their firm in this way. If the firm is not willing to purchase its own shares, it can instead purchase another company’s shares. Firms with a surplus of cash and a shortage of good investment opportunities often turn to mergers financed by cash as a way of redeploying their capital. Some firms have excess cash and do not pay it out to stockholders or redeploy it by wise acquisitions. Such firms often find themselves targeted for takeover by other firms that propose to redeploy the cash for them.

1. ELIMINATING INEFFICIENCIES

Cash is not the only asset that can be wasted by poor management. There are always firms with unexploited opportunities to cut costs and increase sales and earnings. Such firms are natural candidates for acquisition by other firms with better management. In some instances “better management” may simply mean the determination to force painful cuts or realign the company’s operations. Notice that the motive for such acquisitions has nothing to do with benefits from combining two firms. Acquisition is simply the mechanism by which a new management team replaces the old one.

A merger is not the only way to improve management, but sometimes it is the only simple and practical way. Managers are naturally reluctant to fire or demote themselves, and stockholders of large public firms do not usually have much direct influence on how the firm is run or who runs it. Having a block of large shareholders is a sure way of exerting pressure of managers to be more efficient. Acquisitions are the easiest way to create a block shareholding.

**DUBIOUS REASONS FOR MERGERS**

The benefits that we have described so far all make economic sense. Other arguments sometimes given for mergers are more dubious. Here are two.

DIVERSIFICATION

Managers of a cash-rich company may prefer to see that cash used for acquisitions. That is why we often see cash-rich firms in stagnant industries merging their way into new but growing industries. What about diversification as an end in itself? It is obvious that diversification reduces risk. Isn’t that a gain from merging? The trouble with this argument is that diversification is easier and cheaper for the stockholder than for the corporation. Why should firm A buy firm B to diversify when the shareholders of firm A can buy shares in firm B to diversify their own portfolios? It is far easier and cheaper for individual investors to diversify than it is for firms to combine operations.

THE BOOTSTRAP GAME (to be discussed in class)

**A WARNING**

The cost of a merger is the premium the acquirer pays for the target firm over its value as a separate company. If the target is a public company, you can measure its separate value by multiplying its stock price by the number of outstanding shares. Watch out, though: if investors expect the target to be acquired, its stock price may overstate the company’s separate value. The target company’s stock price may already have risen in anticipation of a premium to be paid by an acquiring firm.

**ANOTHER WARNING**

Some companies begin their merger analyses with a forecast of the target firm’s future cash flows. Any revenue increases or cost reductions attributable to the merger are included in the forecasts, which are then discounted back to the present and compared with the purchase price:

Estimated net gain = DCF valuation of target including merger benefits – cash required for acquisition

This is a dangerous procedure. Even the brightest and best-trained analyst can make large errors in valuing a business. The estimated net gain may come up positive not because the merger makes sense, but simply because the analyst’s cash-flow forecasts are too optimistic. On the other hand, a good merger may not be pursued if the analyst fails to recognize the target’s potential as a stand-alone business.

**Leveraged Buyouts**

Leveraged buyouts, or LBOs, differ from ordinary acquisitions in two ways. First, a large fraction of the purchase price is debt-financed. Some, perhaps all, of this debt is junk, that is, below investment grade. Second, the shares of the LBO no longer trade on the open market. The remaining equity in the LBO is privately held by a small group of (usually institutional) investors. When this group is led by the company’s management, the acquisition is called a management buyout (MBO). Many LBOs are in fact MBOs.

1. Please visit- http://techcrunch.com/2012/04/09/facebook-to-acquire-instagram-for-1-billion/ [↑](#footnote-ref-1)