Ch 18 (Mergers) Review Questions: 1, 3, 7, 15

Problem 1

Compare and contrast horizontal, vertical, and conglomerate mergers. What is the difference between a pure and an impure conglomerate merger?

Answer:
Horizontal: increase your economies of scale (increase market power, lower costs)
Vertical: buy up supply chain (increase efficiency, reduce costs)
Conglomerate: buying seemingly "unrelated" businesses under one umbrella
Pure conglomerate: The firms have completely unrelated products
Impureconglomerate: That firms' markets are not entirely seperate.

Problem 3

Market-for-corporate-control hypothesis

a) Explain the hypothesis & how it provides an efficiency motive for mergers
b) How can the **event study method** be used to test the hypothesis?
c) Explain how the hypothesis is derived from the efficienct market hypothesis.
What are the main weaknesses with the efficient market hypothesis & therefore the market for corp control hypothesis?

Answer:

a) The **market for corporate control hypothesis** says that poorly managed firms will face declining profits and ultimately face bankruptcy. Before they go bankrupt, a successful firm may purchase the failing firm and replace management. This threat of takeover will pressure management to **behave efficiently and in the interest of shareholders**.

b) The **event study method** says that mergers are motivated by 1) market power or 2) efficiency. If the merger is motivated by market power, merging and rival firms will see an increase in value. If the merger is motivated by efficiency, merging firms will increase in value but rival firms will decrease.

c) The **efficient market hypothesis** says that stock markets are informationally efficient. The price of each stock reflects all publicly available info and, therefore, reflects the fundamental value.

The **event study method** follows from this. If the efficient market hypothesis is correct, than we should be able to see the resulting movements (from part b) in price following a merger announcement.

Weaknesses of event study:
1) Most aquiring and rival firms are conglomerates, merger won't make that large of a difference
2) A merger may inform other firms of productivity gains and cause them to adopt the same practices

Weaknesses of efficient market hypothesis:
1) Behavioral economics - the presence of "noise traders" who value the firm incorrectly may cause other traders to avoid the stock.

Problem 7

What is the difference between upstream and downstream vertical merger?

Answer:

Both upstream and downstream involve buying up your supply chain.
An upstream merger is where you buy one of your input suppliers.
A downstream merger is where you buy a firm that purchases your product.

Problem 15

Provide two behavioral motives for conglomerate mergers.

Answer:

1) Empire building - psychological rewards from managing large corporations may be more meaningful than building the fundamental value of the firm.
2) Overdiversification - management can over diversify in order to reduce their direct exposure to risk even if the move has a negative impact on the firm

In [ ]: