MERGER and its TYPES

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What is a Merger?

A merger is a corporate strategy to combine with another company and operate as a single legal entity. The companies agreeing to mergers are typically equal in terms of size and scale of operations.

Summary

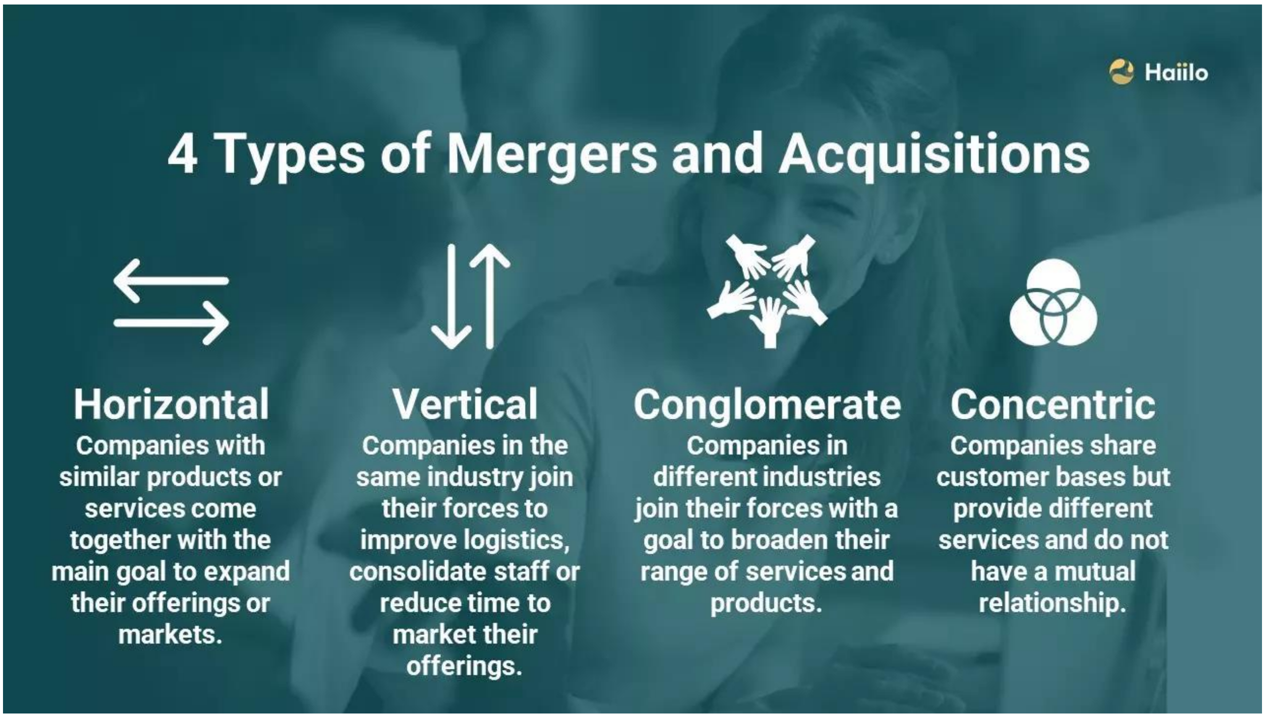
- Companies seek mergers to gain access to a larger market and customer base, reduce competition, and achieve economies of scale.
- There are different types of mergers that the companies can follow, depending on their objectives and strategies.
- A merger is different from an acquisition. Mergers happen when two or more companies combine to form a new entity, whereas an acquisition is the takeover of a company by another company.

Why do Mergers Happen?

- After the merger, companies will secure more resources and the scale of operations will increase.
- Companies may undergo a merger to benefit their shareholders. The existing shareholders of the original organizations receive shares in the new company after the merger.
- Companies may agree for a merger to enter new markets or diversify their offering of products and services, consequently increasing profits.
- Mergers also take place when companies want to acquire assets that would take time to develop internally.

- To lower the tax liability, a company generating substantial taxable income may look to merge with a company with significant tax loss carry forward.
- A merger between companies will eliminate competition among them, thus reducing the advertising price of the products. In addition, the reduction in prices will benefit customers and eventually increase sales.
- Mergers may result in better planning and utilization of financial resources.

Types of Merger



1. Congeneric/Concentric/Product extension merger

Such mergers happen between companies operating in the same market. The merger results in the addition of a new product to the existing product line of one company. As a result of the union, companies can access a larger customer base and increase their market share.

2. Conglomerate merger

Conglomerate merger is a union of companies operating in unrelated activities. The union will take place only if it increases the wealth of the shareholders.

3. Market extension merger

Companies operating in different markets, but selling the same products, combine in order to access a larger market and larger customer base.

4. Horizontal merger

Companies operating in markets with fewer such businesses merge to gain a larger market. A horizontal merger is a type of consolidation of companies selling similar products or services. It results in the elimination of competition; hence, economies of scale can be achieved.

5. Vertical merger

A vertical merger occurs when companies operating in the same industry, but at different levels in the supply chain, merge. Such mergers happen to increase synergies, supply chain control, and efficiency.

Advantages of a Merger

1. Increases market share

When companies merge, the new company gains a larger market share and gets ahead in the competition.

2. Reduces the cost of operations

Companies can achieve economies of scale, such as bulk buying of raw materials, which can result in cost reductions. The investments on assets are now spread out over a larger output, which leads to technical economies.

3. Avoids replication

Some companies producing similar products may merge to avoid duplication and eliminate competition. It also results in reduced prices for the customers.

4. Expands business into new geographic areas

A company seeking to expand its business in a certain geographical area may merge with another similar company operating in the same area to get the business started.

5. Prevents closure of an unprofitable business

Mergers can save a company from going bankrupt and also save many jobs.

Disadvantages of a Merger

1. Raises prices of products or services

A merger results in reduced competition and a larger market share. Thus, the new company can gain a monopoly and increase the prices of its products or services.

2. Creates gaps in communication

The companies that have agreed to merge may have different cultures. It may result in a gap in communication and affect the performance of the employees.

3. Creates unemployment

In an aggressive merger, a company may opt to eliminate the underperforming assets of the other company. It may result in employees losing their jobs.

4. Prevents economies of scale

In cases where there is little in common between the companies, it may be difficult to gain synergies. Also, a bigger company may be unable to motivate employees and achieve the same degree of control. Thus, the new company may not be able to achieve economies of scale.

Mergers

Pros	Cons
• Economies of scale – bigger firms more efficient	• Higher prices – if monopoly power increases
• Lower prices from the efficiency of scale and synergy	• A firm with monopoly power may become inefficient
• More investment and research from higher profits	• Two very different firms may struggle to merge
• Can save an unprofitable firm from going out of business	• Less choice for consumers
• Avoid duplication in natural monopoly	• Job losses
	• Diseconomies of scale

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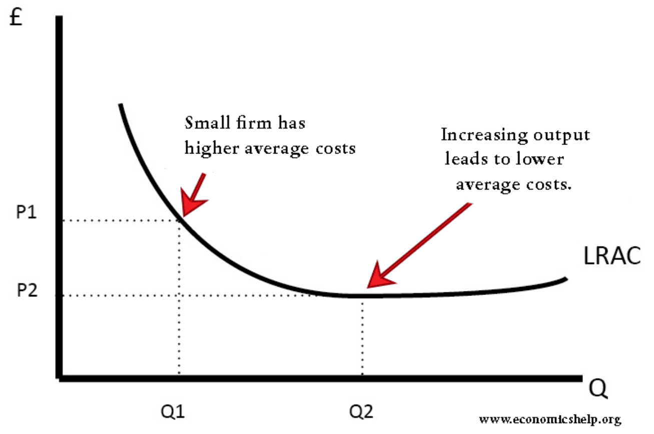
Pros of Mergers

1. Network Economies. In some industries, firms need to provide a national network. This means there are very significant economies of scale. A national network may imply the most efficient number of firms in the industry is one. For example, when T-Mobile merged with Orange in the UK, they justified the merger on the grounds that:

"The ambition is to combine both the Orange and T-Mobile networks, cut out duplication, and create a single super-network. For customers, it will mean bigger network and better coverage, while reducing the number of stations and sites – which is good for cost reduction as well as being good for the environment."

2. Research and development. In some industries, it is important to invest in research and development to discover new products/technology. A merger enables the firm to be more profitable and have greater funds for research and development. This is important in industries such as drug research, where a firm needs to be able to afford many failures.

3. Other economies of scale



Two smaller firms producing Q1 would have average costs of P1. A merger which led to a firm producing at Q2 would have lower average costs of P2.

The potential economies of scale that can arise include:

- Bulk buying – buying raw materials in bulk enables lower average costs
- Technical economies – large machines and investment is more efficient spread over a larger output.
- Marketing economies – A tech firm bought by Google may benefit from Google's expertise and brand name.
- Examples of economies of scale.

In a horizontal merger, economies of scale can be quite extensive, especially if there are high fixed costs in the industry. For example, aeroplane manufacture is now dominated by two large firms after a series of mergers.

If the merger was a vertical merger (two firms at different stages of production) or conglomerate merger, the scope for economies of scale would be lower.

4. Avoid duplication

Too many bus companies can cause congestion – would one be more efficient?

In some industries, it makes sense to have a merger to avoid duplication. For example, two bus companies may be competing over the same stretch of roads. Consumers could benefit from a single firm with lower costs. Avoiding duplication would have environmental benefits and help reduce congestion.

5. Regulation of Monopoly

Even if a firm gains monopoly power from a merger, it doesn't have to lead to higher prices if it is sufficiently regulated by the government. For example, in some industries, the government have price controls to limit price increases. That enables firms to benefit from economies of scale, but consumers don't face monopoly prices.

6. Prevent unprofitable business from going bust

If a firm has been badly managed, it could find itself going out of business. A merger or a takeover may be a way for the firm to survive and many jobs to be saved.

Cons of Mergers

1. Higher Prices

A merger can reduce competition and give the new firm monopoly power. With less competition and greater market share, the new firm can usually increase prices for consumers. For example, there is opposition to the merger between British Airways (parent group IAG) and BMI. (link Guardian) This merger would give British Airways an even higher percentage of flights leaving Heathrow and therefore much scope for setting higher prices. Richard Branson (of Virgin) states:

“This takeover would take British flying back to the dark ages. BA has a track record of dominating routes, forcing less flying and higher prices. This move is clearly about knocking out the competition. The regulators cannot allow British Airways to sew up UK flying and squeeze the life out of the travelling public. It is vital that regulatory authorities, in the UK as well as in Europe, give this merger the fullest possible scrutiny and ensure it is stopped.”

2. Less choice. A merger can lead to less choice for consumers.

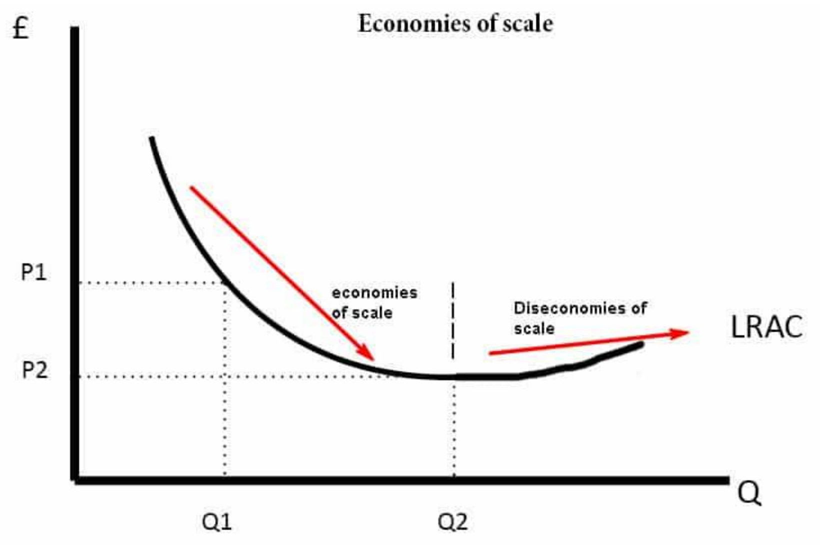
A merger can lead to less choice for consumers. This is important for industries such as retail/clothing/food where choice is as important as price

3. Job Losses

A merger can lead to job losses. This is a particular cause for concern if it is an aggressive takeover by an ‘asset stripping’ company – A firm which seeks to merge and get rid of under-performing sectors of the target firm.

- On the other hand, other economists may argue this ‘creative destruction’ of job losses will only lead to temporary job losses and the unemployed will find new jobs in more efficient firms.

4. Diseconomies of Scale



The new larger firm may experience diseconomies of scale from the increased size. After a merger, the new bigger firm may lack the same degree of control and struggle to motivate workers. If workers feel they are just part of a big multinational they may be less motivated to try hard. Also, if the two firms had little in common then it may be difficult to gain the synergy between the two companies

Evaluation – The desirability of a merger depends upon:

1. **How much is competition reduced by?** E.g. A merger between Tesco and Sainsburys would lead to a significant fall in competition amongst UK supermarkets. This would lead to higher prices for basic necessities.
2. **How significant are economies of scale in the industry?** A merger between Tesco and Sainsburys may enable some economies of scale, but it would be relatively low compared to two oil drilling companies. The fixed costs in oil exploration are much higher. Therefore, there is more justification for a merger in oil exploration than in supermarkets.
3. **How Contestable is the market?** After the merger can new firms still enter or are barriers to entry sufficiently high to deter new firms?
4. **What are the objectives of mergers?** – Are the firms seeking to gain efficiency or are the managers hoping for higher salaries and more prestige in new firms?