

# INCREASING THE ECONOMIC EFFICIENCY OF ENTERPRISES THROUGH MERGERS AND ACQUISITIONS

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**Abstract** - In the literature there are many theories that try to explain why firms adopt the strategy of growth through mergers and acquisitions, or examine the particularities and consequences of this strategy. The purpose of this paper is to highlight, based on certain theories, the most important concepts for understanding the causes and motivations of mergers and acquisitions. Thus, in this paper we address successively the concepts of synergy, market power, information asymmetry, managerial discipline, managerial behaviour, agency costs, transaction costs, barriers to entry.

**Keywords** - mergers, acquisitions, synergies, efficiency, value creation

## I. INTRODUCTION

**M**ERGERS and acquisitions can be tools to improve firms' performance, because they allow cost reductions through economies of scale and scope, entering new markets, better management of sources of supply and sales, best use of the enterprise's basic competences and assimilation of new technologies. Of course, the motives behind mergers and acquisitions are numerous. Next we will analyze the microeconomic determinants of mergers and acquisitions when, by these operations, enterprises aim to increase their economic efficiency.

## II. SYNERGIES – THE KEY TO IMPROVE PERFORMANCE

According to many researchers, such as [1] and [2], the notion of *synergy* provides explanation on the performance of mergers and acquisitions. Synergies are often regarded as one of the main motivations behind the desire of managers to increase the organization they lead, through mergers or acquisitions.

The literature abounds with definitions of synergy that converge towards the same meaning. The concept of synergy corresponds with the efficiency theory, according to which mergers and acquisitions create value through synergies. Realisation of synergies corresponds, overall, to an additional creation of value derived from grouping the companies concerned and which would not have been achieved without the effective realization of this group [3]. This captures the creation of added value through a collaborative process between two entities, higher than the value existing prior to the implementation

of this process [4]. Reference [5] defines synergy as "the potential creation of wealth and the competitive advantage resulting from sharing and use of resources of the two merging firms and that would not have been obtained by any of them independently." Synergistic effects result from a concentration or an integration of entities whose total value exceeds the sum of the values of the individual entities [6].

Reference [1] defines three types of synergies in connection to mergers and acquisitions: operational synergies, which are reflected in reduced production costs or in increased administrative efficiency; financial synergies, which are reflected in reduced capital cost; collusive synergies, which are reflected in the increase of market power, that may lead to an increase in the prices applied. Reference [2] introduced in addition to the three types of synergies stated by [1], the management synergies which refers to the improving the management of the company acquired thanks to the acquirer's competences.

Mergers and acquisitions are often presented as a means to create shareholder value by exploiting all types of synergies between the merged entities. Synergies involve the compensation of the forces and the weaknesses of the two companies but also the sharing of all resources, so that the newly created entity will have the prerequisites for a profitable and sustainable growth and, of course, for value creation. Synergies can find their origin in the increase in size of certain activities, in the sharing of tangible resources, in the exchange of know-how, skills or key competences.

Economies of scale refer to the results and benefits of oversized production due to the increased size of the enterprise: higher production reduces average cost when fixed costs apply to additional units. Economies of scale are the justification most often invoked when a concentration operation is performed [3]. Economies of scale are related to the existence of significant fixed costs (with equipment, R & D, etc.) [7] or of various costs related to the management or marketing activity. Economies of scale can result from an increased bargaining power in the relationship with suppliers or banks [6].

Another form of saving that an entity formed after a merger or acquisition can enjoy is represented by the economies of scope (Baumol and Blinder, cited by [4]). In Baumol and Blinder's opinion, the cost advantage arises when it is cheaper to produce a number of different products together than separately by several companies. In other words, production of several products together, often leads to reduced unit cost, if the company manages to exploit synergies between different activities (range of products including common intermediate consumption, joint marketing, knowledge transfer between different activities). These different pluses correspond to savings generated by the integration of diverse activities [8].

Thus, mergers or acquisitions may be accompanied by sharing of tangible resources and thus they may lead not only to the achievement of economies of scale, but also to a rationalization of inputs and to obtaining economies of scope. However, it should be noted that synergies quantified initially have a certain degree of relativity, as these assumptions are based rather on forecasts on the effectiveness of economic, financial or commercial performances of the new entity created after the completion of the merger or acquisition.

### III. ENTERING NEW MARKETS THROUGH MERGERS AND ACQUISITIONS

One of the reasons behind mergers and acquisitions can be represented by penetration and exploration of new markets or by expansion of their activities to new geographical areas, leading to firm's internationalization. Indeed, the firms' development at an international level becomes more and more a necessity in order to increase competitiveness and success in the competitive struggle.

When firms undertake mergers or acquisitions in order to penetrate foreign markets, they focus on increasing the volume of production, on reducing the costs of inputs, on attracting various tangible and intangible assets or on finding new places for selling the products.

The process of globalization has determined corporations to become truly international entities, and mergers or acquisitions represent tools that can speed up this process. However, the growth of the company through international expansion is considered the most risky due to factors such as local culture, existing regulations, specific competition rules etc. By acquiring a local company that provides infrastructure, customers, formed distribution network, the acquirer will benefit from all these facilities [8]. At the same time, higher economic risks in a country (e.g. in the case of the U.S. recession) and the dynamism of a country with strong economic growth (China, India, Russia, Brazil etc.) are counterbalanced, which has the effect of not affecting the situation of the financial group [9].

In relation to the need to maintain and improve competitiveness, the penetration of foreign markets by mergers or acquisitions allows enterprises to extend their business in short time and it is an effective and quick way to increase market share at the expense of competitors. As [6] affirm, it is important to consider this strategy particularly when sectors reach their maturity,

since the conquest of new markets extends the "lifespan" of the product.

### IV. MERGERS AND ACQUISITIONS - TOOLS OF REDUCING TRANSACTION COSTS

An important strategic decision of the firm lies in finding the balance between what the firm can produce and what would be better to ask others to produce for it. Taking into consideration the production chain, a firm can choose that some intermediate activities to be conducted by external entities or by the company itself. Reference [10] enunciated the transaction costs theory, a theory that justifies this choice. Thus, in Coase's conception, companies grow if the entrepreneurs insource transactions previously operated through market and decrease when entrepreneurs outsource activities previously coordinated within the firm. The option for one of the two resource allocation mechanisms depends on the relative effectiveness of that transaction's governance. The transaction will be insourced / outsourced according to the relative costs involved in carrying out transactions through the market (inter-companies) instead of conducting it within the firm (intra-company). The dilemma of the firm becomes one of the type "make it or buy it" [11]. Through the hierarchical allocation of resources within the company, the latter saves some existing transaction costs due to operating such transactions through the market. Reducing these transaction costs is the main motivation behind the expansion of the organization's borders.

Vertical integration can lead to savings as reflected in the reduction of transaction costs. By acquiring a supplier or a dealer, the acquirer can ensure the continuous flow of supply or distribution process, on the one hand, and on the other hand, the acquirer can gain an advantage in terms of costs of supply or distribution.

Vertical integration involves mergers or acquisitions of companies that are closer to the source of supply or to the final consumer [12]. Upstream-downstream integration is considered a form of complicated and risky expansion, because it consists in integrating various activities of the same chain of value. This form of integration may create disturbances that affect the business processes. But the stakes of this integration and the multiple advantages make it a privileged means to dominate the market and to increase profitably. Downstream integration creates synergies reflected, according to [13], in exclusive contracts, imposing the price, exclusive sales territories, a stable supply source, a more complete range of products and services (which would increase firm's value in the eyes of customers and might prove a necessity for the company to remain competitive [9]), an increase in turnover and margins through cross sales, exchange of know-how etc. At the same time, vertical integration itself generates specific costs, especially bureaucratic costs related to increasing the size of the organization and, as [10] noted, the more the internalized transactions grow in number, the more the entrepreneur may fail to allocate resources in the most profitable way. Also, through the vertical

integration the company may become more rigid and may face different problems of coordinating the organization. Basically, we can talk about inefficiency associated to the bureaucracy of large entities.

#### V. MERGERS AND ACQUISITIONS - TOOLS SUBORDINATED TO THE STRATEGY OF ATTRACTING NEW RESOURCES

In addition to other determinants of mergers and acquisitions presented, another factor that drives the external growth of firms is represented by the acquisition of specific resources. Competitive pressure manifests on all planes so that firms are often put in a position to seize new resources that could help them maintain their competitiveness. Mergers and acquisitions can be a good and very fast solution to achieve that. In contrast, internal growth strategy is less appropriate when new resources should be captured in a short time.

A fundamental reasoning to any merger or acquisition is the anticipation that the transaction will create a value of a certain nature. In terms of transfer of knowledge, of know-how, the creation of wealth results from an organization's ability to transfer information, resources and expertise in order to create and implement new products and processes that will increase the competitive advantage of the organization. Technologies and knowledge can be transmitted either from the target company to the acquiring one, or from the buyer towards the target company, or in both directions. Mutual transfer of knowledge has the greatest influence on the creation of wealth because it is through this transfer that new knowledge arises [14].

One of the objectives of external growth through mergers and acquisitions may be the purchase of certain famous brands [15]. The acquirer has, in this case, the interest to benefit from the reputation of other brands [7]. Buyers often pay substantial premiums for these intangible assets, which, for many, have a much higher value than the tangible assets [9].

External growth through mergers and acquisitions may derive from an innovation strategy based on the two entities' own qualities. Technological innovation may represent the source of its competitive advantage and also of its growth and development.

Lack of key skills required, the costs of research and development and desire to seize innovations determined firms to acquire licenses, to implement of alliances or to pursue mergers and acquisitions. Reasons related to enterprise resource constraints in terms of know-how, the need to obtain these resources in a short time and need to adapt to continuous developments in the sector can make mergers and acquisitions perfect tools in achieving these goals. For example, pharmaceutical companies are pursuing especially the acceleration of the research and development process by acquiring companies that are strong in this direction [12]. Companies like Pfizer and Sanofi-Aventis devote a large portion of annual turnover for research and development [7].

The impact of a technological innovation can be reflected in the loss of leadership position and in

creating opportunities for competitors and new entrants on the market. Therefore, in some sectors (such as the high-tech) leadership position is often fragile and is closely correlated with the research and development and the firms' innovation capacity.

#### VI. MERGERS AND ACQUISITIONS – THE RESULT OF THE CONFLICT BETWEEN STAKEHOLDERS AND OF THE EGO STRATEGY

The agency theory is an extension of managerial theories of the firm and it aims to explain some particular issues arising in the context of separation between ownership and control, and between employed managers and shareholders owning the enterprise. Here we can mention the contributions of authors like [16] or [17] (who introduce the idea of controlling the companies through public purchase offer or public exchange offer). Thus, conflicts of interests between actors participating in the mechanism of an enterprise are integrated into economic analysis by agency theory (or principal-agent theory).

The system of governance of the enterprise (corporate governance) is the implementation of internal and external mechanisms capable to discipline, to control and to encourage managers in order to reduce the potential conflicts of interests between owners of shares and employed managers and to reduce information asymmetry [7]. The mergers and acquisitions market is an external mechanism of controlling the managers. Thus, shareholders unhappy with the performance of companies can cede a part of or all the shares detained, which could decrease the financial performance of the companies. The threat of external takeover of control may require managers to maximize performance; else, they are likely to be replaced by a potential acquirer. Mergers and acquisitions are, as stated also by [18], the court of last resort, in other words the way in which the company can obtain again the desired performance.

Reference [19] set the theory of free cash flow to explain the conflict of interests between shareholders and managers on how to use available cash. He argues that mergers and acquisitions operations could be at their basis managerial motivations and the managers' objectives may not necessarily be to maximize the shareholders' wealth. They prefer to keep financial reserves to fund investment projects, without being concerned by the future profitability of these projects.

The entrenchment theory, proposed by [20], aimed at explaining the mechanisms used by some managers to counteract the control mechanisms. Among the entrenchment strategies there are specific investments (such as acquisitions or mergers), whose process of valorising is directly related to the specific skills of managers. Managers prefer to make investments, sometimes too expensive, but which can strengthen their position within the organization, can provide a more stable job etc.

Corporate strategy should reflect the rational vision conceived by its manager or managers, their capabilities and skills. However, not all of them have these personal

qualities, many have trouble in understanding the enterprise environment or the market trends, and thus are not able to develop an effective strategy. In other cases, deliberately managers do not elaborate realistic development scenarios but rather a personal strategy based on actions that, instead of generating growth and creating wealth, prove to be subordinated to the managers' wish for strengthening their position within the organization, getting awards, bonuses etc.

The theory of managerial hubris, presented by [21], tries to highlight that these operations do not necessarily have economic motivations. Claims and pride of the management team would have then an important explanatory power in terms of multiplication of operations of mergers and acquisitions. The ego syndrome is a contributing factor to what is called "winner curse". Where there are more buyers, several offers for the same target company can emerge. Thus, quite often, managers' pride and a desire not to lose a competition led to a real "war" of the offers, whose outcome was a purchase price too high compared with the actual value of the company [3], [12].

Another explanation argues that the most performant actors of an industry tend to take over weaker ones. Basically, mergers and acquisitions facilitate the competition between different management teams so that weak and inefficient management teams will lose to the strong ones.

## VII. CONCLUSION

Mergers and acquisitions have the scope of improving the economic efficiency of enterprises and they can be used as tools for penetrating new markets, obtaining synergies, gaining access to new resources or reducing transaction costs. Of course, subjectivity and the personal interests of the managers can not be excluded when analyzing determinants of mergers and acquisitions, since managers are often motivated to acquire other firms to maximize their own interests. We can say that this way of growth and development is used by most companies in order to implement restructuring strategies, in accordance with the objectives established and with the development of the business environment. Practically, by the operations of mergers and acquisitions the companies can adapt themselves to changes in their competitive environment and, in order to do that, companies must continuously seek and create new opportunities for growth and development. Concentration is an economic phenomenon and mergers and acquisitions facilitate economic progress and restructuring within the branches. More specifically, when internal control mechanisms are difficult to adapt to the pace of technological innovation, market takeovers occur as a catalyst for change.

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