Mergers and Acquisitions: Boon or Bane?

by
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Introduction

There have been a large number of mergers and acquisitions affecting the economy both locally and nationally[*]. Here are a few recent examples:

- Consolidated Paper and Stora Enso
- Thompson and Gannett Newspaper Chains
- Saint Michael's Hospital/Ministry Health Care and Rice Clinic
- Wausau Insurance and Liberty Mutual
- Wisconsin Central and Canadian Pacific Railroad
- M&I Bank and National City Bancorporation
- Sentry Insurance and John Deere Insurance Group
- Copps and Roundy's
- All-Car Distributors, Inc. and CSK Auto Corporation
- Marshfield Clinic and Wausau Hospital
- Nortek/Peachtree Companies and SNE Enterprises
- Exxon and Mobil Oil Corporation

These corporate combinations raise a number of questions:

- What are the mechanics of mergers and acquisitions?
- Is this merely another example of corporate greed?
- Why do mergers and acquisitions occur?
- What are the impacts associated with mergers and acquisitions?

This report addresses these and other questions by looking at the trends in Central Wisconsin and in the nation as a whole.

Definitions and Mechanics of Mergers and Acquisitions

A merger[2] is a general term for the combination of two or more companies. Strictly speaking, only a corporate combination in which one of the companies survives as a legal entity is called a merger. These corporate combinations can be accomplished in three different ways: by pooling of interests, by purchase acquisition, or by consolidation.

A pooling of interests is generally accomplished by a common stock swap at a specified ratio. For example when M&I Bank[11] merged with National City Bancorporation, the common stock

[*] Throughout the paper, footnotes are designated by one or more asterisk (*), while references are denoted by the superscript number of the reference.

of the two companies were swapped at a ratio between 0.65556 and 0.53636 shares of M&I for every share of National City Bancorporation. This is sometimes called a tax-free merger. Such mergers are only allowed if they meet certain legal requirements. Pooling of interests is less common than purchase acquisitions.

Purchase acquisitions involve one company purchasing the common stock or assets of another company. In a purchase acquisition, one company decides to acquire another, and offers to purchase the acquisition target's stock at a given price in cash, securities or both. This offer is called a tender offer because the acquiring company offers to pay a certain price if the target's shareholders will surrender or tender their shares of stock. Typically, this tender offer is higher than the stock's current price to encourage the shareholders to tender the stock. The difference between the share price and the tender price is called the acquisition premium. These premiums can sometimes be quite high. In the case of the Stora Enso acquisition[12] of Consolidated, the $44 per share offer represented a 69% premium over Consolidated's February 18, 2001 closing price. Why was Consolidated's common stock worth 69% more to Stora-Enso than it was to the market prior to the acquisition's announcement? This is an excellent question that will be addressed in the section dealing with the economic impact of corporate combinations.

The third method of corporate combinations is consolidation. In a consolidation, the existing companies are dissolved, a new company is formed to combine the assets of the combining companies, and stock in the consolidated company is issued to the shareholders of both companies. The Exxon merger with Mobil Oil Company is technically a consolidation. This merger is interesting from an historical perspective because it, in part, reverses the antitrust judgement against the old Standard Oil Trust.

Other terms to be defined are the horizontal, vertical and conglomerate[5] mergers. Horizontal mergers occur when a company merges with another company who is a direct competitor in the same product lines and markets. A vertical merger occurs when a company merges with either a supplier or a customer. Conglomerate mergers occur when the companies combined have no relationship to each other.

Why Do Mergers Occur?

There are a number of reasons that mergers and acquisitions occur. These issues generally relate to business concerns such as competition, efficiency, marketing, product, resource, and tax issues. They can also occur because of some very personal reasons such as retirement and family concerns. However, let's begin our exploration of why corporate combinations occur by discussing an often-cited reason – corporate greed.

Corporate Greed?

Some people say that mergers and acquisitions occur because the greedy corporations want to acquire everything. As far as economic theory is concerned, the primary objective of a firm is to

maximize profits, and thereby maximize shareholder wealth.[**] We can argue about the firm's approach to maximizing profits (e.g., whether being a good corporate citizen increases profits long term, etc.), but any firm, corporation or not, should make decisions designed to increase its profits.

At this point, I am usually accused of paraphrasing the character, Gordon Gecko in the movie *Wall Street*, who said, "Greed is good." I am not saying greed is good; I am saying that the desire for more rather than less is an integral part of the human psyche. When Samuel Gompers[17], the father of the American labor movement, was asked what the members of his union wanted, he didn't say that they wanted some sort of utopia in which everyone got his or her fair share. His response was one simple word, "More!" Ronald Coase, the Nobel Prize-winning economist, once stated, "I have devoted my life to the proposition that economic agents prefer more money to less, and I have found a surprising amount of evidence supporting this proposition."

However, the interesting thing about studying mergers and acquisitions is that it appears that corporations sometimes make decisions that run counter to Coase's proposition. As we shall see when discussing the economic impact of corporate combinations, firms sometimes make decisions that seem to lessen shareholder wealth.

Specific Reasons Why Mergers and Acquisitions Occur (Other Than Greed)

Eliminate Competition

One important reason that companies combine is to eliminate competition. Acquiring a competitor is an excellent way to improve a firm's position in the marketplace. It reduces competition, and allows the acquiring firm to use the target's resources and expertise. Unfortunately, combining for this purpose is *per se* illegal under the antitrust acts[2] as a predatory practice in restraint of trade. Consequently, whenever a merger is proposed, a major part of the resulting press release often deals with how this combination of firms is not anti-competitive, and is done to better serve the consumer. Even if the merger is not for the stated purpose of eliminating competition, U.S. regulatory agencies may conclude that a merger is likely to be anti-competitive. For example, Canadian National's attempt to merge with Burlington Northern Santa Fe[6, 8] was blocked because of concerns that the combination would prompt a series of mergers and acquisitions whose net effect would be to leave the continent with only two transcontinental railroads. Although eliminating competition may result in merger and acquisition activity, it is generally not acceptable to state this as the purpose of such activity. However there are a number of acceptable reasons for combining firms. Let's now examine them.

[**] Milton Friedman would state that this is the only objective of a firm.

Cost Efficiency and the Long-Range Average Cost Curve

Due to technology and market conditions, firms may benefit on a cost basis from being a certain size. Clearly, one way to grow is to combine with other small firms until the firm is optimally sized. Generally, the assumption is that larger firms are more cost-effective than are smaller firms (i.e., that larger firms exhibit *economies of scale* when compared to smaller firms). This is often the stated motive[10] for mergers in the financial services industry.

It is, however, not always cost effective to grow in the financial services industry. In this industry, the long-run average cost curve appears to be virtually flat[4] for financial institutions having total assets of greater than $10 to $20 million. This suggests that in spite of financial institutions' stated reason that merging will improve cost efficiency, larger financial institutions are not necessarily more efficient than smaller institutions. Further, there is some evidence to suggest that very large financial institutions exhibit diseconomies of scale. This means that the average cost per unit increases, as total assets grow too large. Some analysts have suggested that the management may be merging to increase their own prestige. Clearly, managing a company with assets of $100 million is more prestigious than managing a company with assets of $50 million.

How to Avoid Being a Takeover Target by Investing Existing Funds

This is a two-part reason that companies merge. If firm *A* has a great deal of liquid assets, it becomes a tempting takeover target because the acquiring firm can use the liquid assets to expand the business, pay off shareholders, etc. If *A* invests existing funds in a takeover, it has the effect of discouraging other firms from targeting firm *A* because *A* has increased in size, and will require a larger tender offer. Thus, the company has found a use for its excess liquid assets, and made itself more difficult to acquire. Often firms will state that acquiring a company is the best investment the company can find for its excess cash. This is the reason given for many conglomerate mergers.

Improve Earnings and Sales Stability

Improving earnings and sales stability are concerned with reducing corporate risk. If company *A* has some sort of earnings or sales instability, merging with company *B* may reduce or eliminate the instability provided company *B*'s instability is negatively correlated with company *A*'s instability. Suppose company *A* manufactures lawnmowers. Suppose further that company *B* manufactures snow blowers. Thus, company *A* makes money in the summer while company *B* makes money in the winter. If the companies are approximately the same size and have approximately the same sales, then by merging, they can eliminate the seasonal instability. Unfortunately, this is an economically inefficient way of eliminating instability.

Market/Business/Product Line Issues

Often mergers occur simply because one firm is in a market that another wants to enter. All of the target firm's experience and resources (the employees' expertise, business relationships, etc.) are available by buying the targeted firm. This is a very common reason for acquisitions. For

example, Monsanto[***] acquired G.D. Searle because Monsanto wanted to acquire the pharmaceuticals and consumer chemicals (Aspartame) businesses. Sentry Insurance[13] acquired John Deere Insurance Group to enter the market for insuring implement dealers, and transportation. CSK Automotive[7] purchased All-Car to have access to the Central Wisconsin automotive parts market. Similarly, Canadian National purchased Wisconsin Central[6] to enter the U.S. rail market. Whether the market is a new product, a business line, or a geographical region, market entry or expansion is a powerful reason for a merger.

Closely related to these issues are product line issues. A firm may wish to expand, balance, fill out or diversify its product lines. For example, merger and acquisition activities of Nortek/Peachtree Companies[15] are primarily product line related.

Acquire Needed Resources

One firm may simply wish to purchase the resources of another firm or to combine the resources of the two firms. These resources may be tangible resources such a plant and equipment, or they may be intangible resources such as trade secrets, patents, copyrights, leases, etc., or they may be talents of the target company's employees. One reason given for the mergers in the petroleum industry is that companies wish to acquire the leases of their competitors. If acquiring a company for its talent seems strange, consider that Cisco Systems CEO John T. Chambers[5] said, "Most people forget that in a high-tech acquisition, you are really only acquiring people… We are not acquiring current market share. We are acquiring futures." This and the previous section emphasize that often the reasons for mergers and acquisitions are quite similar to the reasons for buying any asset. Both firms and individuals purchase an asset for its utility.

Synergy

Synergy, a term made popular in the 1960's, states that there are efficiencies gained in all the things you do because you do more than one thing. The related popular catch phrase of the time was "two plus two equals five." Synergy is similar to the concept of *economies of scope*. Economies of scope would occur if a meat processing company merged with a leather goods manufacturer, and the combined company was more cost efficient at both activities because each requires the same raw material. Although synergy is often cited as the reason for conglomerate mergers, cost efficiencies due to synergy are difficult to document.

Corporate Tax Savings

Although tax savings[2, 3] may not be a primary motivation for a combination, it can "sweeten" the deal. When a purchase of either the assets or common stock of a company takes place, the tender offer less the stock's purchase price represents a gain to the target company's shareholders. Consequently, the target firm's shareholders will usually experience a taxable gain. However, the acquiring company may reap tax savings depending on the market value of the target company's assets when compared to the purchase price. The acquiring company can write up the target company's assets by the amount that the market value exceeds the net book value of

[***] Unfortunately, I couldn't find a reference for this. However, I was part of the team that performed the analysis, and these reasons were stated to me personally by one of the corporate officers.

the target company's assets. This difference can then be charged off to depreciation with resultant tax savings. This differs from goodwill in that goodwill is never tax deductible. Depending on the method of corporate combination, further tax savings may accrue to the owners of the target company.

Retirement or Cashing Out

For a family-owned business, when the owners wish to retire, or otherwise leave the business, and the next generation is uninterested in the business, the owners may decide to sell to another firm. Retirement or cashing out is locally rumored to be the motivation in the sale of Copps to Roundy's; however, I have been unable to find this explicitly stated by either company in any press release.

For purposes of retirement or cashing out, if the deal is structured correctly, there can be significant tax savings. By using the pooling method, the sellers may be able to account for their sale of their interest[3] as a tax-free exchange. Provided the sellers receive common stock of the purchasing company in exchange for their interest, they can assign the book value of their former investment to the shares received. Therefore, no tax would be due until the shares received are sold. Interestingly, the Copps/Roundy's deal appears to be a straight purchase[14] of shares of about $95 million to about 60 Copps shareholders, and would therefore not have this benefit.

The Impacts of Mergers and Acquisitions

What impacts do mergers and acquisitions have? As any good economist would tell you, the answer is, "it depends." First, it depends on the group of people being discussed. It may also depend on how the deal is structured. Let's discuss each of the various groups involved.

Economic Impacts: Employees

For the employees, being in a merger can be extremely difficult. Generally speaking, when companies merge, there are often layoffs. This was the case for Stora Enso and many of the other companies studied. If the merged company is truly more efficient in a business sense (if not a financial sense), then the merged company will not need to employ as many workers to do the same amount of business. Sometimes, these layoffs are not terribly severe; further, such layoffs may be accomplished by attrition. If the economy is good, and the laid off employees have up to date skills, they may actually benefit from moving. However, typically, the employees laid off are the least valuable to the company, which means that they may be lesser valued to potential employers. Locally, laid off workers may not find the opportunities available to them as financially appealing as the jobs they left. This has a negative impact on the local economy. Although there may not be severe unemployment because jobs are available, the new jobs may not pay as well for lesser-skilled employees. This can have a ripple effect throughout the economy due to decreased incomes for laid off workers.

For the employees who stay, matters may not be much better. Rarely will the merged company have a similar corporate culture. Indeed, the corporate culture may be drastically different.

Changes in business procedures and operating environment can result in severe stress, and, in extreme cases, may lead employees to suffer both emotional and physical problems.

Economic Impacts: Management

The management ranks may suffer more job loss, on a percentage basis, than the employees may. In part, this is due to the clash of corporate cultures. Managers may be charged with implementing corporate polices they might disagree with on behalf of superiors they don't like to employees who may resist change. This is a recipe for high levels of stress. Further, when a company is merged, it doesn't need redundant managers. This means that an existing manager must be either terminated or demoted. Because it may be difficult to defer to someone else when you are used to being in command, demoted managers may also leave. If their skills are up to date, leaving may actually improve a manager's prospects. Although lower levels of management do not benefit from golden parachutes, often, top management has such benefits written into their contracts. Unfortunately, these practices further exacerbate the financial inefficiencies we will discuss in the next section.

Economic Impacts: Shareholders

If the deal is a purchase, the acquired firm's shareholders benefit greatly[1] from the acquisition. The reason for this is that in almost every case the acquiring firm pays too much for the acquisition. If company *A* purchases company *B*, the resulting company will have a lower value than the value of the independent companies summed.

One reason for this overpayment is asymmetric information. The purchasing firm simply doesn't understand what it is buying. Consider purchasing a house. Until the new owners have lived in a house, they probably do not understand all of the quirks associated with the house. Some rooms may be hot or cold, or the basement may leak in the spring. No amount of inspection can reveal all of the problems. The mechanics of the purchase is another reason that acquiring firms spend too much. In order to induce the existing shareholder to relinquish their shares, the acquiring firm has to pay more than the current share price. Because the acquiring company pays too much, the sale of a company with a lot of local shareholders can benefit the local economy. The sale of Consolidated to Stora Enso should benefit central Wisconsin by an infusion of cash[12] from abroad. Unfortunately, this benefit must be weighed against the negative impacts on the managers and other employees.

The economic impact for the purchasing firm's shareholders is strikingly negative. A number of studies have shown that they suffer by at least the same amount that the target firm's shareholders benefit. This is due to the acquisition premium as well as the increased debt load and inefficiencies typically accompanying a purchase acquisition. The reasons given by the acquiring firm's management for the acquisition are often similar to those already covered (more efficient size, product line issues, acquire needed resources, etc.). Whether these reasons would justify the loss due to the acquisition premium has been a subject of study.

A number of studies have attempted to prove that the benefits above offset the acquisition premium. Unfortunately, these studies have almost uniformly concluded that the acquiring firm

is strongly negatively impacted by the acquisition. It should be noted however, that this has been challenging to prove because there are other factors impacting the acquiring company's stock price-general economic upturns, industry-specific news, etc.-which are difficult to separate from the impacts due to the merger. Alternatively some studies have evidence suggestive of positive benefits; unambiguously documenting such benefits, however, has been elusive.

Stora Enso's bid for Consolidated was 69% higher than the previous day's closing[12] stock value. It is difficult to imagine how better management would offset such a premium. This again raises the question, "why was Consolidated's common stock worth 69% more to Stora-Enso than it was to the market prior to the acquisition's announcement?" The empirical evidence argues that Consolidated should not have been worth that much to Stora Enso while Stora Enso's management says that the acquisition was financially justified. The answer to this question is still unclear. Although Stora's premium may be unusually high, it is not uncommon to see acquisition premiums of 25% or more. Indeed, a good trading strategy would be to purchase the shares of likely takeover candidates. Getting back to the issue of greed, paying such premiums suggests that managers may make decisions that do not benefit its shareholders.

What happens if the merger takes place by pooling assets? In this case, the impact of asymmetric information is lessened because the assets of both firms are combined, and there is not as much inefficiency. In other words, there is asymmetric information on both sides that somewhat offsets each other. That is, if company *A* overvalues company *B*'s assets, and at the same time company *B* overvalues company *A*'s assets, the two overvalues make the stock swap for the pooling approach more closely reflect the appropriate values for the combined company.

Any corporate combination, however, is fundamentally economically inefficient. Think about combining the assets of a couple getting married. There are two of everything. Also, each person does things differently. Combining two or more firms is not as economically efficient as an individual investor's purchasing the shares of the companies for her portfolio.

Economic Impacts: What about Competition?

What we haven't talked about is the competitive business environment. Are we heading toward an economy with just a few mega-corporations that control everything? What will happen to the small competitor? The answer depends on the industry's technology and capital structure. For example, some interesting statistics presented at a recent banking seminar at UW-Madison showed that while the rate of mergers was increasing, the overall number of competitors in the financial services industry has remained relatively constant. This suggests that as combinations are reducing the number of competitors, new competitors enter the market. Naturally, these results are industry-specific. For example, it's hard to imagine a mom-and-pop railroad. To be cost efficient, perhaps firms will need to be either extremely small or extremely large. The extremely small firms are like the startup firms in the computer industry 25 years ago. Then, a few kids ran Microsoft and IBM exerted near-monopoly control over the industry. Now, Microsoft is the one fighting the antitrust battles, and IBM is not the power it used to be. The climate for entrepreneurs has never been better, and the economy will be competitive as long as it is open to entrepreneurs with better ideas who can figure out better ways to do things.

What about Debt?

When individuals wish to purchase a house, they often (almost always) go into debt. The assumption is that future earnings will be enough to pay off the debt. According to a source in the banking industry, house loans now may be almost as great as the value of the house. Occasionally, people miscalculate, forecast incorrectly or face an economic downturn, because their income is not sufficient to pay off the debt, and they declare bankruptcy. This is unfortunate, but no one says that we should avoid debt for large acquisitions such as houses or cars. Similarly, corporations sometimes make an acquisition with the assumption that their future earnings will be enough to pay off the debt. Like individuals, corporations sometimes miscalculate, forecast incorrectly or face an economic downturn. This can result in the bankruptcy of the corporation in the same way that it does for individuals.

Economic Impacts: Economic Colonization?

Economic colonization relates to the question, "What will happen if the outsiders come in and take away all our jobs?" This concern ignores the concept of comparative advantage, which states that if each person or country specializes in what it does *comparatively* best, the entire *global* economy will improve. If companies in Wisconsin can produce more efficiently than companies in other places, then the production will occur in Wisconsin. This, of course, assumes a level playing field. That is, it assumes that foreign countries do not unfairly subsidize their industry, markets are allowed to work, and so on. Policing the local as well as international market is an important legitimate function of government, as is providing programs to update the skills of the workforce that may be displaced by market changes. With those caveats, foreign acquisitions probably produce a positive net impact on local economies for several reasons.

The first is, of course, the comparative advantage argument discussed above. Also, with foreign acquisitions, the capital goods acquired by foreigners will stay here, as will foreign money spent to acquire the local companies. In the 1980's, when Japanese companies were acquiring American landmarks such as the Empire State Building and Rockefeller Center there was a tremendous uproar. However, those landmarks are still here (at least they were the last time I was in New York), and the Japanese yen spent to purchase them was paid to shareholders in the U.S. Consider what happens when a tourist comes into central Wisconsin and spends money on cheese, it is seen as a great boon for the economy. Stora Enso spent $4.9 billion[12] to buy a local company. I think that that is also a net benefit for central Wisconsin. As for jobs being for sale, any job is for sale at the right price. Even my job is for sale if someone is willing to pay the right price to UWSP and to me.

Summary

This paper has discussed mergers and acquisitions in central Wisconsin. It has reviewed the basic mechanics of corporate combinations and the reasons (both legitimate and illegitimate) that such combinations occur. We found that corporate combinations are similar to the kinds of combinations and acquisitions that individuals often undertake in their everyday lives. Further, acquisitions are often made for solid business reasons. Although the acquisition may be made

for sound and understandable reasons, the acquiring company typically pays too much. This is due to asymmetric information and the mechanics of a tender offer. We also reviewed the economic impacts of mergers and acquisitions on the employees, management, shareholders, and the competitive economic environment. We found that the impact of mergers and acquisitions are mixed – generally positive for the target firm's shareholders, but negative for the acquiring firm's shareholders as well as the resulting company's employees and management. One final caveat is that each acquisition is complex with its own unique set of costs and benefits.

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