

5.7: Mergers and Acquisitions

6. Why are mergers and acquisitions important to a company's overall growth?

A **merger** occurs when two or more firms combine to form one new company. For example, in 2016, Johnson Controls, a leading provider of building efficiency solutions, agreed to merge with Ireland's Tyco International, a leading provider of fire and security solutions, resulting in a company that will be a leader in products, technologies, and integrated solutions for the building and energy sectors. The merger is valued at \$30 billion, with new Johnson Controls PLC to be based in Ireland. Currently, AT&T and Time Warner have an \$85.4 billion merger pending. "Once we complete our acquisition of Time Warner Inc., we believe there is an opportunity to build an automated advertising platform that can do for premium video and TV advertising what the search and social media companies have done for digital advertising," AT&T's CEO Randall Stephenson said in a prepared statement. Mergers such as this one, in a well-established industry, can produce winning results in terms of improved efficiency and cost savings.¹¹

In an **acquisition**, a corporation or investor group finds a target company and negotiates with its board of directors to purchase it. In Verizon's recent \$4.5 billion acquisition of Yahoo, Verizon was the acquirer, and Yahoo the target company.¹²

Worldwide merger activity in the first quarter of 2017 was mixed. The volume of deals was lower but with higher dollar value. The total number of deals fell by 17.9 percent versus the first quarter of 2016; however, the overall deal value was \$678.5 billion.¹³ We will discuss the increase in international mergers later in this chapter.

Types of Mergers

The three main types of mergers are horizontal, vertical, and conglomerate. In a **horizontal merger**, companies at the same stage in the same industry merge to reduce costs, expand product offerings, or reduce competition. Many of the largest mergers are horizontal mergers to achieve economies of scale. Its \$1.25 billion acquisition of trucking company Overnite allowed UPS, the world's largest shipping carrier, to step up expansion of its heavy freight-delivery business, thus expanding its product offerings.¹⁴

In a **vertical merger**, a company buys a firm in its same industry, often involved in an earlier or later stage of the production or sales process. Buying a supplier of raw materials, a distribution company, or a customer gives the acquiring firm more control. A good example of this is Google's acquisition of Urchin Software Corp., a San Diego-based company that sells web analytics software and services that help companies track the effectiveness of their websites and online advertising. The move enables Google to bolster the software tools it provides to its advertisers.¹⁵

A **conglomerate merger** brings together companies in unrelated businesses to reduce risk. Combining companies whose products have different seasonal patterns or respond differently to business cycles can result in more stable sales. The Philip Morris Company, now called Altria Group, started out in the tobacco industry but diversified as early as the 1960s with the acquisition of Miller Brewing Company. It diversified into the food industry with its subsequent purchase of General Foods, Kraft Foods, and Nabisco, among others. Later spinning off many businesses, current product categories include cigarettes, smokeless tobacco such as Copenhagen and Skoal, cigars, e-vapor products such as MarkTen, and wines.

A specialized, financially motivated type of merger, the **leveraged buyout (LBO)** became popular in the 1980s but is less common today. LBOs are corporate takeovers financed by large amounts of borrowed money—as much as 90 percent of the purchase price. LBOs can be started by outside investors or the corporation's management. For example, the private equity firm Apollo Global Management LLC agreed to buy U.S. security company ADT Corp. in the largest leveraged buyout (LBO) of 2016.¹⁶

Often a belief that a company is worth more than the value of all its stock is what drives an LBO. They buy the stock and take the company private, expecting to increase cash flow by improving operating efficiency or selling off units for cash to pay off debt. Although some LBOs do improve efficiency, many do not live up to investor expectations or generate enough cash to pay their debt.

Merger Motives

Although headlines tend to focus on mega-mergers, "merger mania" affects small companies too, and motives for mergers and acquisitions tend to be similar regardless of the company's size. The goal is often strategic: to improve overall performance of the merged firms through cost savings, elimination of overlapping operations, improved purchasing power, increased market share, or reduced competition. Oracle Corp. paid \$5.85 billion to acquire Siebel Systems, its largest competitor in the sales automation programs market.¹⁷

Company growth, broadening product lines, acquiring technology or management skills, and the ability to quickly acquire new markets are other motives for acquiring a company. Yahoo Inc.'s \$1 billion cash purchase of a 40 percent stake in China's biggest e-commerce firm, Alibaba.com, instantly strengthened its ties to the world's second largest internet market.¹⁸

Purchasing a company can also offer a faster, less risky, less costly option than developing products or markets in-house or expanding internationally. Amazon's 2017 purchase of Whole Foods Market, an upscale grocery chain, for \$13.7 billion was a move to enter the retail grocery sector. In addition to the new product market, this move offers Amazon opportunity to sell Amazon tech products in the grocery stores as well as access to an entirely new set of data on consumers.¹⁹

Another motive for acquisitions is financial restructuring—cutting costs, selling off units, laying off employees, and refinancing the company to increase its value to stockholders. Financially motivated mergers are based not on the potential to achieve economies of scale, but rather on the acquirer's belief that the target has hidden value to be unlocked through restructuring. Most financially motivated mergers involve larger companies. In January 2018, Brookfield Business Partners, a subsidiary of Canada's Brookfield Asset Management, announced that it plans to acquire Westinghouse Electric Co LLC, the bankrupt nuclear services company owned by Toshiba Corp., for \$4.6 billion. Brookfield has a history of turning around distressed businesses.²⁰

Emerging Truths

Along with the technology boom of the late 1990s, merger activity also soared. Total annual transactions averaged \$1.6 trillion a year. Companies were using their stock, which had been pushed to unrealistically high levels, to buy each other. When the technology bubble burst in 2000, the level of merger activity dropped as well. It fell even further after the United States was attacked on September 11, 2001. Then massive corporate wrongdoing began to surface. Stocks plummeted in reaction to these events, and merger transactions, which generally track stock market movements, fell as a result.

Today, merger activity is once again on the rise. Propelled by a solid economy, low interest rates, good credit, rising stock prices, and stockpiles of cash, 2016's \$3.84 trillion of global M&A was historically a very strong year, with several blockbuster deals.²¹

Size is definitely an advantage when competing in the global marketplace, but bigger does not always mean better in the merger business. Study results show that heady mega-mergers can, in fact, be a bust for investors who own those shares. So companies are wise to consider their options before stuffing their dollars in the biggest merger slot machine they can find. In their eagerness to snare a deal, many buyers pay a premium that wipes out the merger's entire potential economic gain. Often managers envision grand synergies that prove illusory or unworkable or buy a company that isn't what it seems—not fully understanding what they are getting.

Integrating acquisitions is both an art and a science. Acquirers often underestimate the costs and logistical nightmare of consolidating the operations of merged companies with very different cultures. As a result, they may fail to keep key employees aboard, sales forces selling, and customers happy.

Companies will always continue to seek out acquisition candidates, but the fundamental business case for merging will have to be strong. So what should companies look for to identify mergers with a better-than-even chance of turning out well?

- A purchase price that is low enough—a 10 percent premium over market as opposed to 50 percent—so the buyer doesn't need heroic synergies to make the deal work.
 - A target that is significantly smaller than the buyer—and in a business the buyer understands. The more “transformational” the deal, such as entering a new business arena, the bigger the risk.
 - A buyer who pays in cash and not overinflated stock.
 - Evidence that the deal makes both business and financial sense and isn't purely the brainchild of an empire-building CEO.
- Mergers are tough—culturally, commercially, and logistically. The most important quality a company can bring to a merger may be humility.

CONCEPT CHECK

1. Differentiate between a merger and an acquisition.
2. What are the most common motives for corporate mergers and acquisitions?
3. Describe the different types of corporate mergers.

This page titled [5.7: Mergers and Acquisitions](#) is shared under a [CC BY 4.0](#) license and was authored, remixed, and/or curated by [OpenStax](#) via [source content](#) that was edited to the style and standards of the LibreTexts platform.

- **4.7: Mergers and Acquisitions** is licensed [CC BY 4.0](#). Original source:
<https://courses.lumenlearning.com/waymakerintromarketingxmasterfall2016>.