MOKSLAS – LIETUVOS ATEITIS
SCIENCE – FUTURE OF LITHUANIA

2009, 1 tomas, Nr. 3
2009, Vol. 1, No 3

Verslas XXI amžiuje
Business in XXI Century

WHY COMPANIES DECIDE TO PARTICIPATE IN MERGERS AND ACQUISITION TRANSACTIONS

Eglė Duksaitė[1], Rima Tamošiūnienė[2]
Vilnius Gediminas Technical University
E-mail: [1]egle_duksaite@yahoo.com; [2]rimtam@vv.vgtu.lt

Annotation. The article describes the most common motives for companies' decision to participate in mergers and acquisitions' transactions. It underlines the importance of the growth factor, whereas the following factors – namely, synergy, diversification and so on – just support the growth motive. Since mergers and acquisitions involve two different parties – the buyer and the seller – the examples of reasons from both perspectives are provided too

Keywords: mergers and acquisitions, reasons, motives.

Introduction

Have you ever heard about Vodafone's merger with Mannesman in 1999 (transaction worth 172.2 billion $), BHP Billiton's merger with Rio Tinto in 2008 (transaction worth 147.4 billion $), America Online's merger with Time Warner in 2000 (transaction worth 112.1 billion $) (Reuters)? Or PKN Orlen's acquisition of Mažeikių Nafta for 5800 million litas in 2006, TeliaSonera's acquisition of Lietuvos Telekomas for 2040 million litas in 1998 or Mid Europa Partners' acquisition of Bitė for 1554 million litas in 2007 (Verslo žinios, Intellinet database)? These are just a few examples of the biggest mergers and acquisitions (M&A) transactions worldwide and in Lithuania. M&A's are radically changing the corporate landscape not only worldwide, but in Lithuania as well. Driven by the philosophy of shareholder value, they form a new economic, social and cultural environment. But what are the reasons behind them?

Definitions

According to Gaughan (2007), DePamphilis (2003), Scott (2003), a merger is a combination of two corporations in which only one corporation survives and the merged corporation goes out of existence. In a merger, the acquiring company assumes the assets and liabilities of the merged company. Moreover, although the buying firm may be a considerably different organization after the merger, it retains its original identity.

An acquisition occurs when one company takes a controlling ownership interest in another firm, a legal subsidiary of another firm, or selected assets of another firm such as a manufacturing facility (DePamphilis 2003). In other words, an acquisition is the purchase of an asset such as a plant, a division, or even an entire company (Scott 2003).

On the surface, the distinction in meaning of "merger" and "acquisition" may not really matter, since the net result is often the same: two companies (or more) that had separate ownership are now operating under the same roof, usually to obtain some strategic or financial objective. Yet the strategic, financial, tax, and even cultural impact of a deal may be very different, depending on the type of transaction (Sherman, Hart 2006).

Fundamental Question: Buy versus Build

Many years executives and entrepreneurs have been searching for efficient and profitable ways to increase revenues and win as big market share as possible. It is obvious that no matter how big or small the business is, in order to be in line with shareholders' expectations it is crucial to grow.

The growth options are as follows (Sherman, Hart 2006):

- Internal or organic growth (e.g. hiring additional salespeople, developing new products, expanding geographically, which, in fact, is a very time and strength consuming option);
- Inorganic growth (e.g. acquisition of or merger with another firm, often done to gain access to a new product line, customer segment, or geography) or by external means (e.g. franchising, licensing, joint ventures, strategic alliances, and the appointment of overseas distributors, which are

© Vilniaus Gedimino technikos universitetas
http://www.mla.vgtu.lt
ISSN 2029-2341(print)/ISSN 2029-2252 (online)

available to growing companies as an alternative to mergers and acquisitions as a growth engine).

In response to the good growth prospects, mergers and acquisitions, just like internal investments, are the means for companies to increase their capital base, as concluded by Andrade, Stafford (2004).

It is obvious that companies may grow within their own industry or they may expand outside their business category, which means diversification. If a company seeks to expand within its own industry they may conclude that internal growth is not an acceptable alternative. For example, let's imagine that a company has a window of opportunity that will remain open for only a limited period of time – in this case slow internal growth may not suffice. If the company grows slowly through internal expansion, competitors may respond quickly and take the available market share. Even advantages that a company may have can dissipate over time by the actions of competitors. The only solution may be to acquire another company that has the resources, such as established offices and facilities, management, and other resources, in place. There might be many opportunities that must be acted on immediately – otherwise they disappear. It could be that a company has developed a new product or process and has a time advantage over competitors. Even if it is possible to patent the product or process, this does not prevent competitors from possibly developing a competing product or process that does not violate the patent. Another example would be if a company developed a new merchandising concept. Being first to develop the concept provides a certain limited time advantage. If not properly taken advantage of, it may slip by and become an opportunity for larger competitors with greater resources.

Another example of using M&A to facilitate growth is when a company wants to expand to another geographic region. It could be that the company's market is in one part of the country but it wants to expand into other regions. Alternatively, perhaps it is already a national company but seeks to tap the markets of other nations, such as a U.S. firm wanting to expand into Europe or contrary. In many instances, it may be quicker and less risky to expand geographically through acquisitions than through internal development. This may be particularly true of international expansion, where many characteristics are needed to be successful in a new geographic market. The company needs to know all of the nuances of the new market and to recruit new personnel and overcome many other hurdles such as language, culture and similar barriers. Internal expansion may be much slower and difficult.

What variables should a growing company consider in striking the right balance between organic growth (build) vs. mergers and acquisitions (buy)? These include (Sherman, Hart 2006):

– The competitiveness, fragmentation and pace of marketplace and industry;
– The access to and cost of capital;
– The specific capabilities of management and advisory teams;
– The strength and growth potential of current core competencies;
– The volatility and loyalty of distributions channels and customer base;
– The degree to which speed to market and scale are critical in business (including typical customer acquisition costs and timeframes);
– The degree to which company operates in a regulated industry.

Growth is the most common reason cited as a motive for M&A transactions. For example, let's have a look at Societe Generale Consumer Finance acquisition of General Financing, a Lithuanian entity specialized in consumer credit activities (including the brand Kreditas123). Jean-Francois Gautier, Head of Specialized Financial Services of Societe Generale Consumer Finance declared: "The acquisition of General Financing allows us to set foot on the new fast-growing market while relying on the local knowledge of one of the leaders of consumer finance in Lithuania". "This acquisition is a timely coincidence of Societe Generale strategic entry to Lithuanian consumer finance market and of General Financing's goal to have a strong, established funding base necessary for further rapid expansion," commented Karolis Pocius, partner of GILD Bankers. "With the coming of Societe Generale Consumer Finance, UAB „General Financing" has completed its first stage of development and obtained one of the strongest possible partners to expand further its market share. Despite a controversial macroeconomic outlook, the company is now set for rapid expansion", - commented the general manager of General Financing Raimondas Rapkevičius.

Synergy as a Reason for Mergers and Acquisitions

Gaughan (2007) states that the term "synergy" is often associated with the physical sciences rather than with

economics or finance. It refers to the type of reactions that occur when two substances or factors combine to produce a greater effect together than that which the sum of the two operating independently could account for. Simply stated, synergy refers to the phenomenon of 2 + 2 = 5. In mergers this translates into the ability of a corporate combination to be more profitable than the individual parts of the firms that were combined.

The two main types of synergy are (DePamphilis 2003):

1. Operating synergy, which consists of both: economies of scale (or the spreading of fixed costs, such as depreciation of equipment and amortization of capitalized software; normal maintenance spending; obligations such as interest expense, lease payments, and union, customer, and vendor contracts; and taxes, of over increasing production levels); and economies of scope (which refers to using a specific set of skills or an asset currently employed in producing a specific product or service to produce related products or services).
2. Financial synergy, which refers to the impact of mergers and acquisitions on the cost of capital of the acquiring firm or the newly formed firm resulting from the merger or acquisition. Theoretically, the cost of capital could be reduced if the merged firms have uncorrelated cash flows, realize financial economies of scare, or result in a better matching of investment opportunities with internally generated funds.

Access to Intangible Assets

The emergence of the knowledge era since the 1980s has brought significant change in both global and local markets. Knowledge, as a core organizational resource and the basis for the development of organizational capabilities, is playing a key role in driving changes in companies. Today the value of knowledge-based, intangible resources has grown geometrically in companies. The intangible assets include (Saint-Onge, Chatzkel 2009):

1. Human capital, which is the sum of all the capabilities of everyone who is currently working in a company, i.e. the cumulative knowledge, experience, attributes, competencies, and mindsets of all employees, managers, and leaders. These individual capabilities of employees create value for the customers.
2. Customer capital, which consists of the strategies, structures, processes, and leadership that translate into a company's specific core competencies. These organizational capabilities leverage employees' individual capabilities to create value for customers. Structural capital also includes the organizational capacity and physical systems used to transmit and store intellectual material. Structural capital is composed in a large part of:

– company's organization (investment in systems, operational philosophy, and supplier and distribution channels),

– innovation (capability to renew a company along with the outcomes of innovation, which include the ability to anticipate market needs and lead the market in responding, the ability to bring new products to market rapidly, intellectual assets and intellectual property (which include copyrights, patents, trademarks, and trade secrets), company's brand and theory of your business. Although the best-known innovation capital is usually intellectual property, these are even more critical to company's well-being),

– processes (comprises all the processes of the company that enable to create and deliver goods and services to both internal and external customers. These can be production, design, and product development processes; people development processes; communication processes; strategy-making processes, and knowledge development, capture, and leveraging processes).

3. Structural capital, which is the sum of all customer relationships, that can be defined by four parameters:

– depth – penetration or share of customers' wallets,

– breadth – coverage or share of the market,

– sustainability – the durability of relationship with customers,

– the profitability of company's relationships with all customers.

Furthermore, human capital interfaces with customer capital and structural capital to create knowledge value capital. These weightless assets now have a greater value in organizations than physical or financial assets. This has been coupled with fundamental changes in legal, competitive, and global requirements. For example, one such quantum shift is the emergence of the European

Union (EU), with its dismantling of boundaries and reduction of trade barriers. The emergence of the EU has also led to a shift in the regulatory environment in Europe, creating pressures to combine organizational strengths simply to be able to compete on a larger scale.

A merger or acquisition can open up and recombine the resource sets of the two companies involved. For example, the intangible, financial, and tangible assets of Company A are joined with the clusters of those resources from Company B. In a merger or an acquisition, there are unprecedented opportunities to bring these resources from the acquiring and the acquired companies together in novel ways – and in ways that were not previously possible – to produce significant gains in your company's overall performance and wealth. This is the potential promise of a merger or acquisition. It is not merely adding the cumulative resources of one company to those of the other, but a recombining of all resources: financial, tangible, and all the dimensions of intangibles (Saint-Onge, Chatzkel 2009).

For example, Symantec's acquisition of Axent Technologies in 1999. That "acquisition was also the catalyst for changing Symantec processes to support an enterprise business. Axent had systems in place for serving major corporate customers, and just as important, its senior executives had an understanding of the service and support needs of that market. As the former Axent executives assumed leadership roles at Symantec, they helped guide the company's investment in and deployment of new systems to undergird the new enterprise thrust" (Fisher 2009).

Another example is the acquisition of Fontes Vilnius by MPS Enterprises Ltd., which is an EU-based, private partnership corporation. Pasis Hartunen, the managing director of MPS for Baltic region, says that "the purpose of the transaction is to settle down in quickly developing Lithuanian and Baltic human resource consulting market. We will be looking for opportunities to provide new services to the current and prospective clients in Baltics and international markets". Alternatively, Regina Laimikienė, the managing partner of Fontes Vilnius, says that "now we will be able to learn from the long-lasting experience of the leading corporation and its broad spectrum of services, which was formed while working in international markets. This transaction will allow us to offer a greater value to the client, but also to provide with the exceptional human resources decisions. This way we can become a trustworthy partner not only in Lithuania, but also abroad."

So, in today's knowledge economy intangible assets, which are seen as organization's most valuable assets, are also the most fragile and difficult to control since they depend on the goodwill and commitment of people.

Other Reasons for Mergers and Acquisitions

Apart from growth, synergy and access to intangible assets motives, there are several other reasons that drive companies to engage in M&A, which are widely reported in the literature:

- Horizontal and vertical integration (Gaughan 2007). Horizontal integration refers to the increase in market share and market power that results from acquisitions and mergers of rivals. Vertical integration refers to the merger or acquisition of companies that have a buyer-seller relationship.
- Improved management (e.g., belief of better management of target's resources), research and development (e.g. it is critically important for the future growth of many companies, particularly pharmaceutical companies) and/or distribution (e.g., when there is no direct access to ultimate customers) (Gaughan 2007).
- Tax benefits (certain studies have concluded that acquisitions may be an effective means to secure tax benefits) (Ghosh, Jain 2000);
- Changes in markets, e.g. regulatory changes, reallocation of market power (Cassiman, Colombo 2006).
- Changes in technology and industry, e.g. emergence of new businesses and markets, new forms of communications and cross-border restructuring (Cassiman, Colombo 2006), reaction to deregulation, increased foreign competition, financial innovations, oil price shocks (Andrade, Stafford 2004).
- Cost reduction (Kreitl, Oberndorfer 2004).
- Extension of R&D capacities (Kreitl, Oberndorfer 2004).
- Obtaining a new customer base (Kreitl, Oberndorfer 2004).

While all the above mentioned motives fall under the buyer's perspective (and this is widely reported in the literature), we must not forget that any M&A transaction also includes the other side – the seller. Frankel Hence, (2007) and Sherman with Hart (2006) provide the motives for M&A from the two different perspectives. Since

the buyer's perspective has been analyzed above, let's have a look at the seller's motives, which include the following points:

- Company does not have the resources to grow further;
- Because a company thinks it has maximized growth in its own market and does not think it can expand to new markets;
- It thinks it reached its historical peak of its valuation;
- Lack of viable replacement for the founder of the company, as the founder approaches to retirement;
- Lack of access to capital (including the restrictions of borrowing capacity);
- If the company is owned by investors, they might want to cash out;
- New competitors emerge.

It is obvious that the choice to sell is one of the most dramatic – last and big decision that a company will ever make. It has an influence on everyone, associated with the company. At the same time, the decision to be a buyer today is a standard business tool, utilized by many, if not most, companies.

Conclusions

To sum up, the following conclusions can be made:

1. Mergers and acquisitions are understood as a general global trend associated with a global corporate restructuring across industries.
2. All the motives for mergers and acquisitions transactions might be divided into: primary and secondary drivers.
3. The primary reason for companies to participate in mergers and acquisitions transaction is growth.
4. The secondary motives – namely, synergy, access to intangible assets, diversification, horizontal and vertical integration and so on – arise from the primary companies' motive to grow.
5. Most of the motivations for mergers and acquisitions feature serve as means of reshaping competitive advantage within their respective industries. However, it may be that some of the motives identified affect some industries more than others, and in that sense they can be expected to be associated with a greater intensity of mergers and acquisitions in certain sectors rather than others.

Literature

Andrade, G.; Stafford, E. 2004. Investing the economic role of mergers, *Journal of Corporate Finance* 10: 1–36.

Cassiman, B.; Colombo, M. G. 2006. *Mergers and Acquisitions: the Innovation Impact*. Edward Elgar Publising.

DePamphilis, D. 2003. *Acquisitions and Other Restructuring Activities: An Integrated Approach to Process, Tools, Cases, and Solutions.* Butterworth-Heinemann.

Fisher, L. M. *Symantec's Strategy-Based Transformation* [accessed on 1 February, 2009]. Available from Internet: <http://www.strategy-business.com/press/16635507/8424>.

Frankel, M. E. S. 2007. *Mergers and Acquisitions Deal-Makers:Building a Winning Team.* John Willey & Sons.

Gaughan, P. A. 2007. *Mergers, Acquisitions, and Corporate Restructurings.* John Wiley & Sons.

Ghosh, A.; Jain, P. C. 2000. Financial leverage changes associated with corporate merger, *Journal of Corporate Finance* 6: 377–402.

Intellinet database [accessed on 1st of February, 2009]. Available through Deloitte intranet.

Kreitl, G.; Oberndorfer, W. J. 2004. Motives for acquisitions among engineering consulting firms, *Construction Management and Economics* 22: 691–700.

Saint-Onge, H.; Chatzkel, J. 2009. *Beyond the Deal: Mergers & Acquisitions that Achieve Breakthrough Performance Gains*. McGraw-Hill.

Scott, D. L. 2003. *Wall Street Words: An A to Z Guide to Investment Terms for Today's Investor.*

Sherman, A. J.; Hart, M. A. 2006. *Mergers and Acquisitions from A-Z.* Amacom.

Verslo žinios website [accessed on 1st of February, 2009]. Available from Internet: <www.vz.lt>.

KAS LEMIA ĮMONIŲ SPRENDIMĄ DALYVAUTI SUDARANT SUSIJUNGIMŲ BEI ĮSIGIJIMŲ SANDORIUS

E. Duksaitė, R. Tamošiūnienė

Santrauka

Straipsnyje apibūdinami įmonių susijungimų bei įsigijimo sandoriai bei analizuojamos pagrindinės priežastys, lemiančios įmonių sprendimą prisidėti prie tokių sandorių sudarymo. Jame pateikiamos teorinės perspektyvos kartu su keliais jau įvykusiais įmonių susijungimo ir įsigijimo pavyzdžiais, pabrėžiamas įmonių nepaliaujamas noras plėsti veiklą, t. y. augti, kuris ir yra pagrindinis veiksnys, lemiantis įmonių susijungimą bei įsigijimą. Kiti veiksniai – sinergija, nematerialus kapitalas, veiklos diversifikacija ir pan. – yra tik antriniai, gaunami iš pirmojo – augimo – veiksnio. Kadangi sudarant tokius sandorius dalyvauja dvi šalys – pardavėjas ir pirkėjas, pateikiami tiek pardavėjo, tiek pirkėjo argumentai.

Reikšminiai žodžiai: susijungimai, įsigijimai, priežastys, motyvai.