Analysis on Theory and Applicability of Mergers and Acquisitions

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Abstract. Motivations and modes of mergers and acquisitions (M&As) are discussed in theoretic and realistic aspects. The best applicable merger theory in China is analyzed considering the efficiency of capital market and team managers.

Background

Commons is regarded as the first who put forward the "transaction is the basic unit of economic analysis"[1], he argued that an economic organization was not only a technical reflection, and was set up to coordinate transactions both realistic and potential conflicts of interest. He defined three basic types of "trade": (1) Transactions, to refer to the exchange through the market; (2) the transactions of management, to exchange within the organization; (3) transactions of quota, namely those made between government and personalities. This is the earliest practical description on the nature of the firm, however, because of the identity of Commons' institutional economists, the theory is not recognized widely.

Coase pointed out in "the nature of the firm"[2] : "It seems cost from the price mechanism that reduces to make profits by establishing companies." Meanwhile he writes in "the problem of social cost" [3], "In order to transact in markets, it is necessary to find out who wants to trade more, the desire and the way of trading, as well as contract through bargain negotiations and supervising terms to be strictly performed, etc. The costs of these transactions are often so high that so many transactions which could fulfill in the no cost pricing system would vanish like soap bubbles." Coase thus defined the nature and boundary of enterprise [2], "considering analyses of economy trend from the private enterprise rather than from the industry, it is necessary not only to define 'enterprise' clearly, but also to tell it from those in 'real world'. If any, they should be understood." Definition of the enterprise and its boundary from Coase, the Nobel Prize winner, is accepted widely.

Motivations of Mergers and Acquisitions

Where is the reasonable boundary between enterprises and the market and the two main modes of transactions have been proposed and explored by economic management theory and practice in recent decades. In the real operation of enterprises, chain enterprises continue to flourish, which means the market is replacing the potential corporate operating costs. On the other hand, mergers and acquisitions also staged again and again in the world, multinational corporations are completing transactions through their own organization instead of market. The two modes are seemly opposite while could obtain profits similarly, which is incredible, but logical essentially. Its features of the industry cause the two opposite trend. In some competitive industries, the competition among enterprises is far greater than the monopoly, and bigger scale means more sunk cost. Therefore, in such type of industry, companies with smaller sunk cost show more prominent competitive advantages, especially facing policy risks, price risks or systemic risks, and these small businesses are more likely to win. In other fields, such as coal, petroleum, natural gas, aviation, or railway transportation, industry barriers stay high because of large numbers of specific assets, which is commonly referred to as the oligopoly industry. According to David J. ,Collis, the specific assets can be identified by the following three aspects: the specific location, specific material assets, and specific human capital. The horizontal mergers can distribute sunk specific assets cost into larger outputs, while vertical mergers can put specific asset cost into enterprise. Therefore, it's more beneficial for oligarch monopoly industry to expand the scale of enterprises by mergers and acquisitions. In China, in spite of energy industry, coal enterprises were impacted by supply and demand exceeding domestic oil companies. The most important reason is the scale of enterprises is relatively too small, lack of pricing right. So it's the best choice to expand scale by merger. Then merger is endless? The modern property rights theory argues, when the marginal market transaction cost is equal to marginal operating cost, the expansion of the scale of enterprises will stop. That is to say, when saving market transaction cost from enterprise expansion is just exhausted by growth of the management fee due to business expansion, the motivation of enterprise expansion is lost. So, enterprise expansion is not unlimited, and its boundary is inevitable.

Can the reality verify the theory? Since the last century, mergers and acquisitions produce a lot of super large enterprises. At the beginning of the last century, Standard Oil Trust, General Motors and American Steel Corp are the examples. In the 60's of last century, International Telephone Telegraph Corporation (ITT) and Radio Corporation America (RCA) also became giants through mergers and acquisitions. Therefore, in the natural monopoly industry, the economic scale is relatively high, and the enterprise through the continuous expansion of the size of the economy, the industry is more competitive.

Modes of mergers and acquisitions

What are modes of mergers and acquisitions? Although the concept of merger and reorganization of assets is widely used in the domestic and international capital markets, it is difficult to domestically find an exact definition. In the practice of managing listed corporations in China, the reorganization of assets is divided into four types: equity transfer, ,acquisition, divestitures or the sale of equity, and asset replacement. The classification of asset reorganization in China Securities News every year is in accordance with this method. Therefore, the domestic mergers and acquisitions and divestitures are of asset restructuring sub category, which actually belongs to the reorganization of the concept of generalized recombination.

Compared with the domestic foreign definition of the reorganization of the concept, they are different. The restructuring generally refers to given company assets and equity, changes and adjustments were made within the company, which is called reorganization by some China's domestic economic scholars, and is also named reconstruction by other researchers engaged in the multinational corporation research, such as Mao Yunshi, Wang Huan and Mao Yunshi (1999), Shi Zhuomin (2000). J. Fred Weston defined takeover, mergers, restructuring and corporate control as mergers and acquisition in the book of merger, corporate restructuring and corporate control.

Mergers and Acquisitions Theory and Application in China

For enterprise mergers and acquisitions (M & As), the relatively common view of the previous studies include: the goal of the merger is to obtain economy scale and synergy (efficiency theory), consolidation can produce monopoly interests (market power theory), eliminating the unqualified manager through the acquisition can solve the principal-agent problem (agent theory), moreover, some studies consider the investment diversification to spread risk or reasonable tax avoidance as mergers and acquisitions motivation, etc. These theories are reasonable, can independently explain the disposable merger behavior alone, while it is difficult to explain the formation of the wave of mergers and acquisitions. The historical experience shows that, mergers and acquisitions mostly appear wave type. Mitchell, Mulherin (1996) and Harford (2005) found that mergers and acquisitions involving the industry is more likely produced by capital sufficient liquidity, regulations changes or technology shocks. That is to say, some industries are more prone to frequent mergers and acquisitions, changes in the industrial policy of the government or industry to adjust capital limited less area. By far, as the six waves of mergers and acquisitions that happened in America proved each period of mergers and acquisitions is also the period of economic expansion, then a sharp drop of stock price index followed. This conclusion allows researchers to pay more attention to the relationship between mergers and acquisitions and stock value of the batch type. Some recent studies, such as Maksimovic and Phillips (2001), Javanovic and Rousseau (2001) research shows there is strong correlative between mergers and overvalued stock market capitalization companies. This may explain those phenomenons of mergers and acquisitions which have been considered abnormal in accordance with the previous merger theory. For example, cash acquisition is better than the stock acquisition[4], the value of the acquisition of the acquisition of[5], better than the popular small bidding company better than the Large Firm[6]. Then, Shleifer and Vishny (2003)[7], Rhodes-Kropf and Viswanathan (2004)[8] model proves that the stock market valuation errors are the main driving factors for mergers and acquisitions, however, it should not be ignored that they assume in the model financial market belongs to the weak effectiveness, and managers of the voting company are completely rational. Once the rational managers realize the value of the stock market is apart from the reasonable scope, they will seize the market opportunity and make full use of the deviation, in order to obtain the benefits of mergers and acquisitions. This theory is called the market timing theory which is supported by Rhodes-Kropf's (2005)[9] experience research.

Although China's financial market has experienced rapid development in recent two decades, the overall efficiency is not high yet, and the capital market can be regarded as a low efficient market. Considering the generally high level of domestic team managers, the collective decision-making means relatively higher ration, and they can be regarded as completely rational. Therefore, the author argues that the motivation of M & A from domestic listed corporations is suitable for this theory in China.

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