

Mergers and acquisitions

A merger is the amalgamation of two or more firms into a single firm. This is typically accomplished by one firm acquiring the assets of the other firm(s). Hence such transactions are referred to as mergers and acquisitions (M&As). There are three types: horizontal mergers involving firms in the same industry, vertical mergers between firms at different stages of the production chain, and conglomerate mergers between firms in unrelated industries.

There are at least three reasons why it is interesting to examine M&As from an international perspective. First, cross-border M&As have fueled the growth in international production for more than a decade. Specifically, most foreign direct investment (FDI) is carried out through the acquisition of foreign firms' assets rather than the creation of new firms, also known as greenfield investment. Second, there is evidence that economic integration affects M&A activity by increasing the incentives to undertake cross-border M&As, and by forcing industries to restructure. This restructuring is often accomplished through M&As. Third, both cross-border mergers and mergers between domestic firms engaged in international trade pose challenges for competition policy. Such mergers affect several countries and are hence subject to review by different national competition authorities. These authorities may come to conflicting conclusions, especially if some countries bear more of the costs, while others receive more of the benefits of the merger. A prominent example of such conflicts is the merger between two American companies, General Electric (GE) and Honeywell, that was approved by US authorities but ultimately blocked by the European Commission.

Cross-border M&As account for a significant and growing share of total M&A activity. They now make up around 25% of worldwide M&As, considerably more in the European Union. Between 1996 and 2005, the annual average value of cross-border M&As worldwide was \$533 billion, or about 70% of annual world FDI flows (UNCTAD, 2006). Cross-border M&As, like all M&A activity, tend to occur in waves. In 2000, for example, cross-border M&As peaked at \$1.14 trillion. Most cross-border M&As are between developed-country firms. FDI in developing countries is still dominated by greenfield investment. Horizontal mergers account for roughly 70% of all cross-border mergers, vertical mergers for around 10%. Mergers are much more common in the service sector than in manufacturing (UNCTAD, 2000).

Horizontal mergers have attracted the most attention both in the literature and from competition authorities. The study of these mergers typically involves an analysis of the following two aspects. First, horizontal mergers tend to be anti-competitive. They raise industry concentration, and hence potentially lead to higher prices for consumers or, in the case of intermediate goods, for downstream industries. Another consequence of increased industry concentration is that competitors may benefit even more from the merger than the merging firms themselves. Specifically, if the merging firms raise their prices following the merger, competitors will gain market share at the expense of the merging firms.

Second, a merger may allow firms to realize synergies and thus become more efficient. Firms will merge provided that these synergies are sufficiently big to offset the competitive disadvantage outlined in the previous paragraph. If the efficiency gains from the merger are large, prices for consumers may even fall as a result of the merger. But even if they do not, a competition authority may approve a horizontal merger provided that the efficiency gains in production are larger than the losses suffered by consumers due to higher prices. How competition authorities should weigh consumer wellbeing and economic efficiency in their decisions is an issue that has generated some debate in the literature.

In the preceding analysis we did not distinguish between domestic and cross-border M&As, simply because it applies to both. Still, it is important to point out some of the distinguishing features of cross-border mergers. The main motive for horizontal cross-border M&As is to establish a market presence abroad. They are therefore an alternative to greenfield FDI or exporting. Compared to these alternative choices, cross-border M&As tend to raise industry concentration, thereby potentially hurting consumers and benefiting local competitors. However, they also offer additional efficiency advantages. These include the avoidance of set-up costs and of the fixed costs of operating a production facility arising in the case of greenfield FDI, and the avoidance of transportation costs and trade barriers associated with exporting.

M&As may not involve a complete takeover of another firm's assets. Rather, an investor may acquire a majority or even only a minority stake. This raises the question of what the appropriate ownership structure of the newly created entity should be. Partial ownership entails the sharing of control rights, and implies different levels of commitment by the parties involved. There is no clear dividing line between M&As and other forms of organization that allow firms to share assets and coordinate their interests, such as *joint ventures*.

Economic integration affects M&A activity in at least two ways. First, it puts pressure on firms to restructure. Specifically, less efficient firms in an industry are forced by import competition to contract or close, whereas improved access to export markets offers more efficient firms an opportunity to expand. An empirically important way in which this restructuring is accomplished is through M&As, whereby efficient firms acquire the assets they need to expand from less efficient firms (Breinlich, 2006). Second, trade liberalization raises the incentive to undertake cross-border mergers. A simple example illustrates the point. Suppose there are two countries, *A* and *B*, each with one firm. When trade barriers are high, there is no incentive for the firms to merge, since each already has a monopoly in its market. As trade barriers fall, competition between the firms increases, giving them an incentive to merge in order to reduce competition.

Except in the European Union, where large cross-border mergers and mergers involving domestic firms with a significant market share in other EU member countries are reviewed by the European Commission, competition policy generally remains the responsibility of national authorities. This may cause problems exactly for the reasons that have led the EU to implement a union-wide competition policy. A simple example helps illustrate them. Consider an industry where two locally owned firms in country *A* export all their output to country *B*, and suppose there are no local competitors in *B*. A horizontal merger between the two firms allows them to monopolize the market in *B*. This hurts consumers in *B*, but raises profits for the firms in *A*. Synergies involving the elimination of fixed production costs have no effect on prices and hence only boost profits. Provided that competition authorities are guided by considerations of national wellbeing, the competition authority in *A* would approve the merger, the one in *B* would prohibit it. This raises the possibility that a merger would be blocked even if the efficiency gains accruing to the firms in *A* outweigh the losses suffered by consumers in *B* so that a merger would raise the overall welfare of the two countries.

The case of the GE/Honeywell merger mentioned above is much more complicated than the case illustrated by this simple example. In particular, it does not only have a horizontal dimension (both companies produce jet engines for regional aircraft), but also a significant vertical dimension. Specifically, Honeywell is a leading supplier of an intermediate good, namely engine starters, to GE and its two main competitors in the market for large jet engines.

A merger between GE and Honeywell may thus have allowed them to cut off supplies to these two competitors, thereby monopolizing the engine market.

Vertical mergers are best viewed as an alternative to vertical contractual arrangements – also known as vertical restraints – between firms and their suppliers and/or distributors. An analysis of vertical mergers – like in the case of horizontal mergers – involves weighing efficiency-enhancing against competition-reducing effects.

See also: Foreign Direct Investment, Joint Ventures

Further Reading

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Neven, Damien J., and Lars-Hendrik Röller, eds. 2005. Special Issue on Merger Control in International Markets, *International Journal of Industrial Organization* 23, 665 – 848.

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