CHAPTER – II
CORPORATE MERGER AND ACQUISITION: STRATEGIES & CAPITAL MARKET RISK

2.1 MEANING: CORPORATE MERGER AND ACQUISITION:

Corporate merger and acquisition is the process of buying, selling, and integrating different corporations with the desire of expansion and accelerated growth opportunities. This kind of association in any form plays an integral role when it comes to business and economy as it results in significant restructuring of a business.

The key objective of corporate mergers and acquisitions is to increase market competition. This objective can be achieved by using different methods of merger like horizontal merger, conglomeration merger, market extension merger, and product extension merger. All these types of merger work towards a common goal but behold different characteristics suited to get the best outcome in terms of growth, expansion, and financial performance.

In many significant ways, this kind of restructuring a business proves to be beneficial to the corporate world. It greatly helps to share all resources, skills, talents, and knowledge that eventually increase the wisdom bar within the company. This can further help to combat the competitive challenges existing in the market.

Further to that, elimination of duplicate departments, possibility of cross selling, reduction of tax liability, and exchange of resources are other big time benefits of corporate merger and acquisition. This not only helps to cut the extra cost involved in the operation and gain financial gains but also help to expand across boundaries and enhance credibility. This in the long run will help increase revenue and market share, fulfilment of the only desire that drives the growth of merger & acquisition.¹

2.2. THEORIES OF CORPORATE MERGER & ACQUISITION: The six theories, which deal the corporate merger and acquisition is given as under:

1. The Efficiency Theory.
2. The Monopoly Theory.
3. The Valuation Theory.
4. The Empire Building Theory.
5. The Process Theory.
6. The Disturbance Theory.

1. The Efficiency Theory:

The Efficiency theory states that the more efficient companies will acquire less efficient company and realize gains through improved managerial efficiency. The ultimate aim of merger and acquisition is to produce synergy. Following a merger, companies should have the capability to improve overall efficiency, which is not possible before the merger. In effect, it means that costs are reduced when both companies use the same production facilities. Synergies can be obtained in three ways, which are as under:

(a) Financial Synergies: financial synergies spreading the risk of the buyer’s investment portfolio through the acquisition of a new business sphere. The advantage generated by the improved financing opportunities of the extended company is another such effect.

(b) Operating Synergies: operating synergies arising as a rule from the fusion of individual functional areas within the new company, such as the merging of two production facilities. The transfers of knowledge in another operative synergy so that the know-how is increased as different corporate divisions combine their competencies and abilities.

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2 Ibid.
Innovation strength may also increase as company experts are brought together at one location.

(c) **Management Synergies:** management synergies arising out of the management of the company initiating the purchase having competencies which can contribute to the efficient organisation of processes in the target company or vice versa.⁴

2. **The Monopoly Theory:**

According to the classical economic theory of monopolisation, companies agree to horizontal mergers in order to achieve market strength, limit the competitors’ power and make access to the market more difficult for them. The positive effects of a monopolistic market position can be obtained by (a) Cross-Subsidisation of acquired business lines; (b) Restriction of competition in markets where a company becomes a participant through acquisitions; and (c) Implementation or augmentation of entry barriers in specific markets

In the cross-subsidisation of single business-lines, profits originating from the strong position of a product in a particular market can be utilised to finance entry into other markets. Further, a simultaneous restriction of a competition in several markets can result from introducing two companies in the most important market of the other company through takeover. Finally, constructing market entry barriers is aiming at deterring potential competitors from entering the respective market, and this can be accomplished through acquisitions in adjacent markets.

3. **The Valuation Theory:**

Merger or acquisition of company takes place primarily because their corporate values or business values are being speculated on. Investors hope to purchase companies whose products are undervalued in the market, in order to increase their values and to add value to their targets. The idea of increasing the

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corporate value is directly linked to shareholder value addition. Shareholder value describes the value of a company from its stakeholder’s point of view, who uses it as the benchmark in judging the efficiency of a company. From this perspective, the decision to invest in or acquire other companies is a pure investment decision which must be reflected in the increase in shareholder value.\(^5\)

4. The Empire Building Theory

Mergers serve the personal interests of management which make efforts to influence the company they purchase (for increasing the turnover) and win over with the increased profit generation for the owners or the capital providers. Conflicts between the owners and the management of a company do not, however, always stand behind the various aims of turnover and profit maximisation. A careful examination of merger waves in United States until the turn of the century shows that the power motive of management began to dominate the profit motive of the owners, the empire building theory emphasises that the management, with excessively optimistic expectations and interests (which differ from those of the owners), generally tend to pay a higher price for a company acquisition.

5. The Process Theory

Mergers are the results of complex decision-making processes. The extent to which these processes can be planned and foreseen by the decision-makers is limited and that is why the stakeholders need to strike a balance between different interests, which holds weight throughout the process. In this context, the following aspects are important:

(a) The limited ability of individuals for the reception and processing of information, which means that there is restricted information processing capacity of individuals and therefore the search for

\(^5\) Ibid.
information and alternative decisions is insufficient, and that judgement can be made only on the basis of incomplete information.

(b) The prevalence of particular business routines in organisation, which means that members of an organisation tend to approach new problems with existing strategy.

(c) The significance of political relationships and their effect on the processes and the results of decision-making in organisations.

(d) Limited information processing capacity and political relationships within an organisation. The existing political conditions within an organisation can mean that decisions are frequently influenced by one person who behaves according to his self interest or by pressure groups who behave according to their groups’ interests.

6. The Disturbance Theory:

Merger triggered by economic events and trends (such as fluctuations in commodity prices or the effects of globalisation) occur in periodic waves. Market control can be attained through horizontal, vertical and conglomerate mergers. Viewed historically, the first wave of merger and acquisition consisted primarily of horizontal mergers, the second of vertical, and the third of conglomerate mergers.

Macro-economic shocks or disturbances change the attitudes and expectations of the managements creating an economic atmosphere characterised by increased uncertainty. This necessitates a company to consider the possibility of an acquisition, as well as to dispose of its stake in another company. It must be pointed out, however, that there are examples of macro-economic disturbances which challenge even the Disturbance Theory. For instance, no wave of mergers followed the oil crisis of 1973-74 on the one hand while on the other, there were no considerable macro-economic changes that precipitated the merger and acquisition wave in the end of the 1960s.⁶

⁶ Supra Note 3, PP. 4-5.
2.3. RATIONALE FOR CORPORATE MERGER AND ACQUISITION:

The rationale for corporate merger and acquisition for the acquiring company and the selling company is as follows:

1. Acquiring company:
   (a) Diversification to achieve economic protection.
   (b) Adding new products faster.
   (c) Acquiring management or technical personnel.
   (d) Acquiring profitable operations.

2. Selling Company:
   (a) Major stockholders wishing to retire.
   (b) Need for further financing.
   (c) Means of survival.
   (d) Prospect of marketing or technology changes.
   (e) Attractive purchase or exchange offer.

3. Successful Merger and Acquisition:
   (a) The committee approach is suitable for merger and acquisition deals.
   (b) Defining general objectives and policies.
   (c) Prospective acquirer information:
      • History and background.
      • Organizational structure and personnel.
      • Product lines.
      • Marketing methods and areas served.
      • Research and development.
      • Financial position.
   (d) Prospective companies for acquisition:
      • Horizontal, vertical or diversified.
      • Method of deal: cash or stock.
      • Size of companies: sale and profit range.

7 Supra Note 4, PP. 54-55.
- Product lines.
- Research and development.
- Management.

4. Unsuccessful Merger and Acquisition:
   (a) Major Pitfalls:
   - Insufficient investigation of acquired company.
   - Corporate indigestion: too many companies acquired in too short time in diverse industries.
   - Loss companies in unrelated fields present greater acquisition risks.

   (b) Failure of Mergers:
   - No plan, for fit of plant, personnel and facilities.
   - Inadequate diligence by merger partners.
   - Lack of strategic rationale.
   - Unrealistic expectations of synergies.
   - Paying too much.
   - Conflicting corporate cultures.
   - Failure to move quickly to meld the two companies.

2.4. THE POST MERGER SPATIAL RATIONALIZATION PROCESS:

The majority of post merger process suffered two major shortcomings. First is, mergers are often analyzed as a homogenous whole, while each has its own unique set of motivating factors and consequences. A second major shortcoming is that the spatial impact of merger activity is generally ignored. While it is clear that the re-location or opening of a new plant has spatial implications, only recently has there been a growing awareness of the spatial element in industrial acquisition behaviour.\(^8\)

A major consideration for the success of any acquisition is the geographical compatibility of the production and marketing operations of the

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acquiring and acquired companies. The period of most-acquisition integration usually involves not only the reorganization of managerial control and changes in product lines but also a re-arrangement in the location of company and other corporate functions.\(^9\)

Watts\(^10\) suggests four basic spatial rationalization policies exist, which are as under:

(a) **Specialization**: the concentration of functions that permits realization of economies of scale.

(b) **Concentration and Partial Disinvestment**: the concentration of production at fewer sites allowing, for savings in services and linkages between plants.

(c) **Complete Disinvestment and Greenfield Site**: the concentration of production at a Greenfield site. Also, acquisitions do not always turn out well. One survey reveals that over fifty percent of Companies that undertook an acquisition replied they were dissatisfied with the outcome.\(^11\) However, within one’s own industry the intelligence network reduces the probability of a poor merger choice. Unsuccessful mergers result in a fourth policy.

(d) **Complete Disinvestment and Withdrawal**: the total or almost total removal of newly acquired Company facilities. This may occur when a merger is undertaken that later becomes too burdensome for rationalization to occur. Another possibility is the acquisition of a Company with the intent of stripping it of its assets and selling the assets to make a profit. The impact of mergers on regional development is also inconclusive.

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North\textsuperscript{12} concludes that Companies do not explicitly consider location parameters in making merger decisions for diversification strategies. When attempting horizontal and vertical integration, companies preferred to acquire candidates near the corporate headquarters location. He, further, contended that mergers are often beneficial with respect to employment and output expansion. Acquired plants often experienced increased levels of capital investment although at low levels. The long-run consequences of management change and product change were deemed uncertain.

2.5. MERGER STRATEGY AND ITS IMPACT:

Generally, the word ‘Strategy’ is used to describe the direction that the organization chooses to follow in order to fulfil its object. Strategy is a method or plan chosen to bring about a desired future, such as achievement of a goal or solution to a problem.\textsuperscript{13}

In a ‘Merger Strategy’ two companies agree to integrate their operations on a relatively at par basis so that their combined resources and capabilities create a stronger competitive advantage. The Reckitt & Coleman, U.K. and Benchkiser, Netherlands joined hands to form ‘Reckitt-Benckiser’ with complementary products and geographical penetration. The merger created the world’s leading household cleaning products group and the new company had substantial market power with significant cost reductions and improved profitability.\textsuperscript{14}

A merger strategy is supposed to be consistent with the company’s overall mission, objectives and goals to grow either through new investments in projects or a business combination. A company is expected to set out its business objectives and growth strategy in a clear, rational and financial number oriented way. The criteria should be expressed in clear terms of goals like: (a) diversification of products and services in the related or unrelated


\textsuperscript{14} Supra Note 4.
areas, (b) vertical integration by expanding in acquisition of input and in
distribution, (c) the consequential business risk, (d) expansion of market share
by further investments or acquiring the competitors, (e) geographical access,
new products or technologies, top line (the revenues), bottom line (the profits),
and so on.\textsuperscript{15}

2.5.1 Strategic Approach for Merger:

Famous Strategy thinker, Henry Mintzberg,\textsuperscript{16} has enunciated five
general essentials of strategy, which are as under:

1. **A plan:** Strategy is a consciously intended course of action which a
company chooses to follow after careful deliberations on the various
options available to it. It is not the first alternative that came to the chief
executive’s mind like a flash or a dream.

2. **A ploy:** it is a specific manoeuvre which is intended to outwit an
opponent or a competition. It is trick, a device, a scheme or deception to
gain advantageous position before engaging into the combat of
marketing warfare.

3. **A pattern:** it is not one decision and one solitary action; it stands for a
stream of decisions and actions to guide and tend the future course of
the enterprise until it reaches its predetermined corporate objectives.

4. **A position:** it is means of locating the company in an environment full
of external factors pulls and pushes. On most of those factors, enterprise
has little control and whatever influence it can exercise is constrained by
its organizational capabilities.

5. **A perspective:** it is an ingrained way of perceiving the world around the
organization and its business operations. It is greatly influenced by the
mindset of people who form the dominant interest group and are
involved in taking decisions affecting the future course that the company
takes.

\textsuperscript{15} Ibid.
\textsuperscript{16} Supra Note 14.
2.5.2 Formulating strategies for Merger\textsuperscript{17}:

In the first stage, the company must set out its business objectives and growth strategy in a clear, rational, and data-oriented way. In addition, top executives should establish specific criteria, based on the objectives that they have determined and on a strategy of growth through acquisition, to describe what a viable target company would bring to the party. They should express these criteria in terms of such goals as market share, geographical access, new products or technologies, and general amounts for financial synergy.

Further, following types of questions for the formulation of strategy, should be determined before merger and acquisition.

1. What kind of cost structure should the ideal target have?
2. What kind of market channels should the target provide?
3. What kind of organisational competency and capabilities should the target have?
4. Should the target provide optimum leverage and capital structure and the greatest number of sources of synergies?
5. Should there be acquisitions of strategic customers’ accounts of the target or its value adding market segments?
6. In which part of the world or region should additional capacity be built?
7. How are the acquisition targets to be identified?
8. What kind of business and management structure and governance process of the target will help solid integration?

2.5.3 Level of Merger Strategy\textsuperscript{18}:

Merger Strategies can be visualized to operate at three different levels viz.

(1) Corporate level.
(2) Divisional or Business level.

\textsuperscript{17} Supra Note 4, P. 47.

\textsuperscript{18} www.istor.org/…256154 (Visited on June 09, 2012)
(3) Operational or functional level.

(1) Corporate level:

Strategies at corporate level focus on the scope of business activities i.e. what product portfolios to build, to expand and to consolidate. The growth and diversification strategy has to be spelt out in terms of functions and structures, should it be in the form of multi divisions of the same corporation or should it be a holding group having a number of legally independent companies and how resources have to be allocated to various alternative and competing options. Such strategies are known as grand, overall or root strategies.

(2) Divisional or Business level:

Strategies at Divisional or Business level are directly concerned with the future plans of the profit centre which are divisionalized in large enterprises. These are the sub-strategies as they devolve from the grand strategies and have market orientation because these deal with the current and future product lines.

(3) Operational or functional level:

Strategies at operational or functional level target the departmental or functional aspects of operations and look at the functional strategies of marketing, finance, human resources, manufacturing, information systems etc.

As such, strategic management is the continuous process of coordinating the goals of a company with the economic environment at a macro level, in an effective manner, to reap the opportunities and overcome the threats, considering its strengths and weaknesses.

2.5.4 Merger Strategic Planning:

Merger Strategic planning is an organization’s process of defining its strategy, or direction, and making decisions on allocating its resources to pursue this strategy. In order to determine the direction of the organization, it is necessary to understand its current position and the possible avenues through which it can pursue a particular course of action.¹⁹

It is a management tool, used to help an organization do a better job to assess and adjust the organisation’s direction in response to a changing environment.\textsuperscript{20} The environment in which business organizations operate today is becoming uncertain.

Profitable growth constitutes one of the prime objectives of most of the business organizations. Different organizations may have to use different growth strategies depending on the nature of complexity and quantum of work involved. The top management of the organization ordinarily provides the direction as to which of the strategies would be the most appropriate for a particular company. This will depend upon several factors, including the corporate objectives of the organization. However, many times these are influenced by factors external to the organization over which the management has limited control. Strategic planning is a disciplined effort to produce fundamental decisions and actions that shape and guide what an organization is, what it does, and why it does it, with a focus on the future at the same time.

Though there is no prescribed single ‘silver bullet’ for corporate success, there is continuous need for strategic planning. However, management must understand the holistic nature of strategy and have the determination to adhere to it steadily and steadfastly by using strategic planning as a guide in a time of uncertainty.

\textbf{2.5.5 Importance of Merger Strategic Planning:}

Strategic planning provides the framework for all major business decisions of an enterprise decisions on business, products and markets, manufacturing facilities, investments and organizational structure.\textsuperscript{21}

Strategic planning has the ultimate burden of providing a corporation with certain core competencies and competitive advantages in its fight for survival and growth. It is not just a matter of projecting the future. It seeks to prepare the corporation to face the future. Its ultimate burden is influencing the

\textsuperscript{20} http://www.namac.org/strategic-planning-what. (visited on April 01, 2012)
corporation’s mega environs in its favour, working into the environs and shaping it instead of getting carried away by its turbulence or uncertainties. The success of the efforts and activities of the enterprise depends heavily on the quality of strategic planning i.e. the vision, insight, experience, quality of judgement and the perfection of methods and measures.22

2.5.6 Features of Merger strategic planning:
The salient features of strategic planning are as under:

1. It is an inclusive, participatory process in which the Board and staff take on a ‘shared ownership’.
2. It is key part of effective management.
3. It prepares the company not only to face the future but even shape the future in its favour.
4. It is based on quality data.
5. It draws from both intuition and logic.
6. It accepts accountability to the community.
7. It builds a shared vision that is value-based.
8. It helps to avoid haphazard response to environment.
9. It ensures best utilization of company’s resources among the product-market opportunities. Strategic planning is not a substitute for the exercise of judgement by leadership. So the date analysis and decision-making tools of strategic planning do not make the organization work – they can only support the intuition, reasoning skills and judgement that the personnel contribute to their organization.23

2.6. CAPITAL MARKET RISK:
The capital market risk usually defines the risk involved in the investments. It cannot be diversified and it can also be referred to as the capital

22 Ibid.
23 Supra Note 14.
systematic risk. While an individual is investing on a security, the risk and return cannot be separated.24

The risk is the integral part of the investment. The higher the potential of return, the higher is the risk associated with it. The examination of the involved in the capital market investment is one of the prime aspects of investing. It can be easily said that the risk distinguishes an investment from the savings. The systematic risk is also common to the entire class of liabilities or assets. Depending on the economic changes the value of investments can fall enormously. There may be some other financial events also impacting the investment markets. In order to give a check to the capital market risk, the asset allocation can be fruitful in some cases.25

An investment in stocks or bonds comes with the following types of risks.

(1) Market Risk.
(2) Industry Risk.
(3) Regulatory Risk.
(4) Business Risk.

The market risk defines the overall risk involved in the capital market investments. The stock market rises and falls depending on a number of issues. The collective view of the investors to invest in a particular stock or bond plays a significant role in the stock market rise and fall. Even if the company is going through a bad phase, the stock price may go up due to a rising stock market. While conversely, the stock price may fall because the market is not steady even if the investor’s company is doing well. Hence, these are the market risks that the stocks investors generally face. The industry risk affects all the companies of a certain industry. Hence the stocks within an industry fall under the industry risk. The regulatory risk may affect the investors if the investor’s company comes under the obligation of government implemented new regulations and laws. The business risk may affect the investors if the company
goes through some convulsion depending on management, strategies, market share and labour force.  

2.6.1 Diversification, Systematic and Total Risk:

(A) Diversification Risk:

It is a risk management technique that mixes a wide variety of investments within a portfolio. The rationale behind this technique contends that a portfolio of different kinds of investments will, on average, yield higher returns and pose a lower risk than any individual investment found within the portfolio. Diversification strives to smooth out unsystematic risk events in a portfolio so that the positive performance of some investments will neutralize the negative performance of others. Therefore, the benefits of diversification will hold only if the securities in the portfolio are not perfectly correlated.

(B) Systematic Risk:

Systematic risk is inherent to the entire market or entire market segment. It is also known as “un-diversifiable risk” or “market risk.” A company’s systematic risk, or the sensitivity of its returns to the aggregate returns of the marketplace, determines its cost of capital.

The Corporate level of a company also affects levels of systematic risk by linking individual business units to certain common core technologies. Tangible interrelationships are activities that can be shared between two business units and can result in competitive advantage through technical or scale economies. Intangible inter-relationships are those that allow for the “transference of generic skills or know-how about how to manage a particular type of activity form one business unit to another”.

Additional support for the contention that competitive advantage is associated with lower levels of systematic risk comes from the literature of

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26 Ibid.
30 Supra Note 19.
organization theory, in which the term organizational slack is used in a manner analogous to the use of the term competitive advantage in the literature on strategic management.

(C) Total risk:

Total risk is defined as the total variability in a security’s returns. It is combination of the unsystematic variability and the systematic variability. Depending on the level of a corporation’s diversification, the unsystematic component may vary from 70 to 80 percent of its total risk.

Although proponents of modern financial theory claim that only systematic risk matters to stockholders and the strategic management theorists argue that the management of unsystematic risk is also necessary. Therefore, the management of total risk is important.

In these theories, all stockholders – customers, employees, managers, debt holders, stockholders, and others – have legitimate claims to organizational rewards. To deem the claims of stockholders as paramount amounts to an exclusive focus on systematic risk that will inhibit future co-operative efforts and therefore reduce the total rewards available from an organization.\(^{31}\)

2.7. A MARKET IN LITIGATION RISK:

In the field of market sectors, law practice, known as litigation risk for companies, is another branch of risk management. The very same clients who rely on lawyers to manage legal risk often rely on other experts to manage a variety, of other risks. One expert may evaluate the risk of natural disasters, such as earthquakes. Another expert may focus on market risks, perhaps looking at broad threats to the global economy or perhaps specializing in narrower risks affecting particular industry sectors (for example, home building or computer software) or particular commodities (for example, oil or com).\(^{32}\)

An important difference between litigation risk and risk management in other

\(^{31}\) Supra Note 26.

fields is that, unlike lawyers, professionals in these other fields of risk management not only advise on the nature and extent of risk, but also can relieve risk bearers of risk-enabling them to hedge or offload it through market transactions.33

Further, Risk-transfer mechanisms have developed in these other fields of risk management in large part because experts in these fields have not confined themselves to the singular role of advising risk-bearing clients. Some risk managers perform a function analogous to that of lawyers-helping clients to structure conduct so as to minimize risk. But this is not the only way that a risk expert can put his skills to work. Although the legal profession has come to recognize just how important risk management is to law practice, and lawyers have taken increasingly sophisticated approaches to managing risk for their clients the legal profession has not yet taken the important step that other risk managers have taken toward viewing risk not only as an evil that a particular client may wish to avoid but also as a profit opportunity that some other market participant may wish to embrace. With few exceptions lawyers confine themselves to advising their clients on legal risks-on how best to handle a contract dispute, a regulatory challenge, or a lawsuit-and do not offer clients a way to hedge against legal risk while the relevant problems are still pending34.

It may be that lawyers lack the capital to absorb the downside risk of a catastrophic litigation loss and have not been able to find third-party capital providers willing to accept this sort of risk. Or it may be that even if lawyers could price the risk and find capital providers to absorb it, the lawyer's professional role nonetheless inhibits lawyers from using their skills as market participants in their own right, or as brokers for profit-seeking capital providers, rather than simply as agents for risk-bearing clients. Whatever the reason, though, the legal profession has largely failed to create markets that could relieve risk bearers of legal risk. And, as a result, the risk-transfer

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mechanisms available for legal risks fall well short of those available in other fields. The absence of a well-developed risk-transfer mechanism for litigation risk in particular may help explain why litigation risk is so daunting in businesses. Due to this daunting problem of litigation risk in business industry, the company might have to suffer through protracted, expensive litigation and face the possibility of a devastating judgment. For as long as a lawsuit is pending, then, the defendant remains exposed to a broad range of potential liability that it does not consider to be part of its core business and that it does not want to affect its financial conditions.

The resulting settlement or judgment will also depend upon the performance of company's lawyers and those of the plaintiff, on the views of the presiding judge and/or jury, and on a host of procedural rulings that may be only tangentially related to the merits. Some of these factors-such as the judge, the jury, and opposing counsel -are completely beyond the party's control.

Other factors may be within company's control-for example, hiring a good counsel and an effective, yet cost-conscious, Law Company may reduce total litigation payouts-but even those factors are not within the company's core business mission. The company will want its profits to turn on the quality of its products or services, the effectiveness of its marketing, and the care with which it manages its operating costs. It simply will not want its bottom line to depend upon how well it handles litigation. The risk of paying more or less for a given lawsuit is not the sort of core business risk that the company is ideally suited to bear.

When a company's future prospects depend upon high-stakes litigation, potential lenders and equity investors are even less likely than the company's own management to be able to assess the relevant risks. In some instances, potential lenders and equity investors may consider, pending litigation a deal breaker. If the suit is potentially big enough relative to the size of the company, the potential lender and equity investors may simply be unable or unwilling to


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spend the time to become comfortable enough with the risk. Or, if the capital supplier is willing to proceed despite the risk, it will likely do so on much less favourable terms for the company—compensating it for the risk by reducing its valuation of the company (in the case of an equity investment) or increasing the interest rate it will charge (in the case of debt). The true costs of high stakes litigation to a corporate defendant can thus far exceed the time and money it actually devotes to the litigation process.\(^{36}\)

**2.8. VERTICAL MERGER STRATEGIES AND MARKET RISK:**

Vertical merger involves the integration of companies having supplementary relationships either in production or distribution of products or services. In such cases, both the companies have different level of production processes either of same product or same line of business. In vertical mergers, the acquiring and target companies are in the same industry with strong buyer-supplier relationship. The target company is either a supplier or buyer of the acquiring company. Vertical merger is generally undertaken when market of intermediate product is imperfect. It is called backwards integration when company expands backward towards the source of raw material and forward integration when it moves forward in the direction of customer. For example, RPG groups’ merger with Harrison Malayalam Ltd. Gave its control over rubber, a major tyre input for the other group company – Ceat Ltd. This was vertical backward integration. The effect of such mergers is generally to improve efficiency through improving the flow of production and reduction of stockholding and handling costs. Thus, vertical mergers help to ensure a smooth source of supply or an outlet for product or services.\(^{37}\)

Vertical merger strategies and market risk show the implications of vertical mergers on the risk characteristic of the merging companies. Specifically, it focuses on structural characteristics of the acquiring and acquired company’s market to explain the change in the systematic or

\(^{36}\) Ibid.

\(^{37}\) Supra Note 5.
environmental risk of the acquiring company. These structural characteristics are as under:

1. The level of competition in the acquiring company’s industry.
2. That the vertical mergers are effective at reducing systematic risk particularly when the acquiring company competes in a concentrated market. Further, this appears to be stable across life cycle stages.38

Indeed, industrial organizations, strategic management, and transaction cost economics are three theoretical perspectives about vertical integration. Each perspective suggests somewhat different predictions about the effectiveness of integration to minimize risk. For example, industrial organizations predict that integration will likely lower a company's risk, particularly when the integrating company competes in a structurally powerful industry. Conversely, strategic management predicts almost the opposite. Vertical integration is not an effective means to reduce risk, and it may even increase a company's risk, particularly when that company competes in a structurally powerful industry. According to the strategic perspective, a key contingency factor that explains the risk of integration is the growth rate of the integrating company's industry.

2.9. VERTICAL MERGER, UNCERTAINTY REDUCTION AND SYSTEMATIC RISK

In a world characterized by perfectly competitive and informational efficient input and output product-markets, there are no sustainable advantages from being vertically merged or integrated. All companies, whether integrated or not, will at best earn long-term returns that approximate their respective costs of capital. Any management action that by chance causes a positive deviation from the expected or normal level of return will soon be eroded by competition's counter attack.39 Of course, real world product-markets contain varying degrees of imperfections or failures. Markets fail for a number of reasons that outcomes are not known with full certainty. ‘Uncertainty’ appears

39 Id. at P. 133.
as the fundamental problem for complex organizations and coping with uncertainty is the essence of the administrative process.\(^{40}\)

The transaction cost economics, industrial organizations, and strategic management come two general predictions about the ability of a vertical strategy to reduce demand and supply uncertainty. These predictions are as under:

1. The first prediction is generally supportive of the ability of vertical integration to reduce uncertainty, and is based primarily on transaction cost economics and to a lesser extent on industrial organizations.
2. The second prediction, based on arguments from strategic management, asserts almost the opposite; i.e., vertical integration is not an effective response to environmental uncertainty.

The first prediction assumes information that flows between separable vertical stages can be better managed within organizations than through market stages because internal agents have less initiative to disguise and distort information. Fundamental to understanding the first prediction and its link to systematic risk are the concepts of asset specificity, quasi-rents, and how transaction costs cover with the market environment. Asset specificity refers to those investments that are specific to a particular buyer-seller relationship and may include production capital, human capital, site capital, and brand name capital. When these transaction specific assets are exchanged through open market transactions, price, quantity and all other important terms of the exchange are determined by negotiation and embodied in a contract.\(^{41}\)

The second prediction contrasts with the transaction cost. Based on arguments from strategic management, the second prediction views vertical integration as a less effective response to environmental uncertainty than market exchange responses. Market responses include cooptation by

\(^{40}\) Thompson, "Vertical Mergers, Uncertainty Reduction, and Systematic Risk", 1967, P. 159.

\(^{41}\) Ibid.
interlocking directorates, cooperation through joint ventures and long-term contracts, and actions through the courts.

Five inductive reasons are given, each suggesting that integration strategies may lower a company's cash flows, thereby raising a company's systematic risk. These are as under:

(1) The first strategic management reason is that integration requires a greater need to coordinate input transfers between stages than does a strategy of non-integration, and therefore may incur the higher administrative costs which are associated with inflexible bureaucracies. These higher administrative costs may offset any transaction cost incentives to integrate, and even lower a company's cash flows below what it was before integrating.

(2) The Second, the critical success factors associated with any vertical stage may be substantially different from those of the adjacent stage even though their products or services are interdependent with each other. Failure to recognize these differences may lead to managerial misunderstandings that may also counteract any cash flow potential.

(3) The Third, capacity imbalance may occur in the vertically integrated company, leading to higher production costs than incurred by companies that utilize market mechanisms. Higher production costs, in turn, can amplify the sensitivity of a term’s production function to environmental fluctuations, particularly cyclical downturns when excess capacity is common.

(4) The Fourth, integration, either upstream or downstream, raises exit barriers and may dull competitive incentives. This may make a company more vulnerable to environmental uncertainties and competitor attacks.

(5) Finally, a vertically integrated company may show higher levels of unsystematic, or operating, risk since integration increases a company's

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commitment to one business, and operating risk has been shown to be positively correlated to systematic risk.

Thus, a vertical merger will have a neutral effect on the systematic risk of the integrating company. Industrial organizations, transaction cost economics, and strategic management have advanced different predictions about the influence that market power may have on the risk reducing potential of vertical mergers.\textsuperscript{43}

On the other hand, transaction cost economics asserts that if the target company's industry is competitive, integration is not necessary. This is because in a competitive market, buyers can re-contract with other suppliers if changes in contract specifications need to be made, thus also reducing opportunism\textsuperscript{44}. In other words, when the target comes from a competitive market, the integrating company may neither obtain entry barrier benefits nor necessarily a bargain price. Indeed, integrating into a competitive market may be counterproductive if the internal organization is beset with incentive difficulties, or agency costs\textsuperscript{45}.

2.10. CONCLUSION:

Corporate mergers and acquisitions provide a means whereby a company can grow quickly. As a merger is a combination of two companies where one company is completely absorbed by another company. It may involve absorption or consolidation. In simple terminology, further, mergers are considered as an important tool by companies for purpose of expanding their operation and increasing their profits, which in facade depends on the kind of companies being merged.

Besides the merger process, acquisition is another way for the development and growth of the companies'. Corporate acquisition is an investment in which a company or person buys a publicly-traded company, or, more commonly, most of the shares in that company. The acquisitions occur in exchange for cash, stock, or both. Acquisitions may be friendly or hostile; a

friendly acquisition occurs when the board of directors supports the acquisition and a hostile acquisition occurs when it does not. It is the company’s strategic choice whether it should undertake merger and acquisition for sustainable growth or it would resort to organic expansion. If it is a merger and acquisition, then what would be the type: merger, alliance or any other. The choice is vital. A strategic analysis of merger and acquisition should also be undertaken in the light of value creation logic and identifying the sources of value creation. Companies may acquire another company with the hope of experiencing economic gains. These economic gains may come as a result of economies of scale or economies of gains. Economies of scale are the reductions in per-unit cost that come as the size of a company’s operation, in terms of revenues or units productions, increases. Economies of scope occur when a business can offer a broader range of services to its customer base. Some of these gains are reported as motives for horizontal and vertical acquisitions. Besides these corporate merger and acquisition process, for a successful corporation, strategic planning works as the path finder to various business opportunities, simultaneously it also serves as a corporate defence mechanism helping the company avoid costly mistakes in product market choices or investments.

The merger strategies and capital market risk mainly deals with the changes in systematic risk associated with companies that engaged in merger and acquisition. It also suggests that a well-designed integration strategy may enhance a company's future effectiveness, and the most advantageous time to initiate a merger and amalgamation is when the industry of the integrating company is relatively consolidated, regardless of the industry's life cycle stage. Therefore, at the time of merger and acquisition, merger and acquisition planning must take care of all internal or external communication aspects very carefully.

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