

Analysis of the Risk of Enterprise Merger as Viewed from Merger Motivation

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Abstract

Five merger waves with large scale in the world have fully promoted the growth and grandness of enterprises. However the failure ratios of enterprise merger are very high. In this article, based on the analysis of enterprise merger motivation, we further deeply analyze the risk of enterprise merger in order to enlighten China enterprises which blindly implement mergers.

Keywords: Merger motivation, Risk, Economy of scale, Economy of scope

Since the beginning of the 20th century, five merger waves with large scale in the world have fully promoted the growth and grandness of enterprises. Almost all present world large enterprises grow up through merger. At present, though some enterprises in China adopt merger to make them stronger and larger as soon as possible, but we thought many lessons of enterprise merger in China and foreign countries shouldn't be forgotten. Experiences of US show that at least above half merger activities are unsuccessful. Whereas, following the history of western enterprise merger, based on the analysis of enterprise merger motivation, we further deeply analyze the risk of enterprise merger in order to enlighten China enterprises which blindly implement mergers.

1. Motivation of enterprise merger

The history of western enterprise merger has experienced the developmental process from main horizontal merger to main vertical merger and to main mixed merger. Last two merger waves happened in 1980s and 1990s had presented the tendency of diversification, and three types had not been differentiated clearly. Though western scholars have abroad and deeply studied the problem of enterprise merger, but up to now, there has not formed a systematic theoretic frame. Here, following the history of western enterprise merger, we mainly analyze the main motivation of enterprise merger.

1.1 Effect of scale economy

The so-called scale economy means that under appointed technical conditions, the average cost of unit product will decrease with the increase of output scale. The effect of scale economy mainly roots in following aspects. First, with the increase of output scale, the fixed costs are apportioned on more outputs, i.e. the unit change costs are not changed, and the unit average cost will decrease with the increase of outputs. Second, with the increase of output scale, the labor division becomes more aborative, and when people repeatedly do one job, it will accumulate their experiences and enhance their labor skills, accordingly enhance the labor productivity. Third, the increase of enterprise scale can enhance the credit level of enterprise and the market status of enterprise, and enhance the ability of bargaining of enterprise with suppliers and consumers. Fourth, with the increase of enterprise scale, "reserve with large scale" can be saved. In the industrial production, because of demands of equipment fault and scheduled servicing, appropriate equipment reserve must be possessed to ensure continual production process and replace those equipments with faults or scheduled servicing. However, the reserve equipments needed are not changed with enterprise scale in certain scope. One large enterprise which needs several certain special equipments is same to one small enterprise which only uses one that special equipment, and they both only need one suit of reserve equipment to ensure continual production. In practice, some enterprises implement horizontal merger in order to obtain effect of scale economy to large extents.

1.2 Transaction cost

The so-called transaction cost means the cost that needed to be paid for organizing transaction through market mechanism, which includes payouts of money, time and energy. The general transaction cost can be divided into two sorts. One is the negotiating cost which including searching cost, information cost and bargaining contract paid for signing transaction agreement. And the other is the contract cost, which means the cost paid to prevent that one party breaks contract or agreement items. About the reason of transaction cost, Williamson had analyzed that from three aspects. One is human limited rational thinking, i.e. because people will be influenced by incomplete information and knowledge absence, so they can not objectively and exactly analyze and judge things, which make that both transaction parties can not sign a complete contract beforehand to end both actions. Second is human opportunism

action, i.e. the action that people may harm others' benefits to actualize their own avail maximum. The existence of incomplete contract will further prick up human opportunism action. Third is the capital specialty, i.e. the capital can be used for different aims and different users when it doesn't influence capital values. When one party of transaction or both parties have high mutual dependences in one transaction activity or are in each other's control, such transaction has high capital specialty. The high capital specialty makes the party who possesses special capital is difficult to quit transaction, because the special capital always possesses lower values when it is used in other aspect. Obviously, interior market transaction (i.e. vertical merger) can fully save transaction cost. In practice, some enterprises implement vertical merger just in order to save transaction cost to large extents.

1.3 Effect of scope economy

The effect of scope economy means the situation that the cost induced by that the enterprise offers multifold products or services (including no vertical merger) at the same time is lower than the cost induced by that the enterprise produce every product or service. The production of scope economy effect roots in that one or several resources such as technology, product line, sales channel, brand, reputation, management and culture can be shared by multifold products or services at the same time. In practice, some enterprises implement relative mixed merger just in order to obtain scope economy effect to large extents.

1.4 Diversifying risks

When the enterprise provides multifold non-relative products or services, differences of lifecycle, dependent resources, used technology, involved segment market, national policy changes and influences of international market fluctuation that products or services are in make risks are diversified in different products or services. In practice, some enterprises implement non-relative mixed merger just in order to diversify risks to large extents.

1.5 Enhancing enterprise core competition

For last merger waves happened in 1980s and 1990s, their main motivations of merger are to enhance enterprise core competition. Since 1970s, the information technology has advanced rapidly, the environment faced by enterprise is more complex, and even those large enterprises occupying leading status in the market may be confronted with powerful competition from some nameless small enterprise or other national enterprises. Under this background, more enterprise mergers are to consider merger effect as viewed from enterprise development strategy, which aim is to obtain core competition for long-term development of enterprises.

1.6 Managers' motivations

To pursue the maximum of individual avail, enterprise managers are inclined to rapidly enlarge enterprise scale through merger. Because of rapid increase of enterprise scale can not only enhance managers' incomes, but also enhance managers' social status, so large enterprise always possesses strong risk resistance ability and have larger guarantees of right and occupation. In practice, after merger some enterprises can obtain managers' supports just because of that.

2. The risk of enterprise merger as viewed from merger motivation of enterprise

After we analyze the motivation of enterprise merger mainly following the history of enterprise merger, and as viewed from the motivation of enterprise merger, the risk of enterprise merger mainly roots in following several aspects.

2.1 Not all horizontal mergers can produce the effect of scale economy.

(1) The effect of scale economy only exists in special industry. Characters in these industries include that the fixed cost proportion is high, and the increase of scale can make fixed costs apportion on more outputs. However, in some sporadic industry, special skills are predominant resources of enterprise, such as cooks' cooking skill in the restaurant industry, consultants' knowledge in the consultation industry and so on, and these industries almost have no effect of scale economy. That can explain why the first merger wave with large scale which takes horizontal merger as the main contents in western history is mainly centralized in auto manufacturing, steel, petroleum, chemical industry and other traditional industries. Further speaking, because of technical advance, the fixed cost has been reduced largely, but those traditional industries with high fixed costs make the horizontal merger effect based on the effect of scale economy abate largely. Long-term practices of Japan Toyota Company proved that the special technology and management mode adopted by the enterprise are important reasons to form expensive fixed costs, and new technology and management mode can fully reduce or avoid many fixed costs. Since 1980s, Toyota reduced daily management expenses in auto assembly process through decreasing products in making, mechanical assembly times and overhead expenses of batch production, and the application of CAD also largely reduced fixed costs and direct costs in the design process of new autos.

(2) The production of scale economy effect has certain range. When certain enterprise has achieved optimal scale, the horizontal merger can not reduce fixed costs apportioned by unit product.

(3) When the enterprise scale is larger, the labor costs are always higher. The data of US National Statistics Office showed that the company with over 500 employees paid more 35% of salaries than small company averagely, because workers in large company were easier to establish labor union and had stronger negotiating ability than small company.

(4) With the increase of scale, the labor division becomes more aborative. Though it is propitious to enhance labor productivity, but aborative division makes workers engage single and repetitive works for long-term, inevitably produce boring emotions, reduce production efficiency and enhance demission ratio.

(5) The horizontal merger is easy to be restricted by management. Because of the limitation of management extent, the management layers certainly will be increased, which not only increases overhead expenses, but also easily induce information distortion and reduce communication efficiency.

2.2 When the vertical merger save transaction costs, it can not only increase communicating costs of interior organizations, but can reduce the flexibility of the enterprise.

(1) The horizontal merger makes enterprise transform from original production of single product to the production of relative product, which makes enterprise not only lose efficiency predominance produced by specialty, but also increase communicating costs to retain balances of production ability in relative products. When the expense of one transaction organized by interior "authority" pattern is more than the expense organized by market mechanism, the horizontal merger not only can't reduce costs, but can increase costs. All outsourcing activities, net organization and so on abroad exist in world enterprises fully explain that.

(2) Facing complex market demand and drastic market competition, enterprise must continually properly adjust its products or services. However, horizontal merger largely enhance the exit bulwark of enterprise and certainly will reduce the flexibility of enterprise.

2.3 When fixed merger produces the effect of scope economy and diversify risks, it also increases the complexity of management.

(1) Relative mixed merger may induce negative cooperative effect. For example, once problems occur in certain product sharing same brand, it will produce chain-react and influence other relative products.

(2) Non-relative mixed merger makes enterprise enter a new domain, and the production management processes in different domains possess large differences, which makes management become complex. If the manager is not familiar with this new domain, he cannot diversify risks but can prick up risks.

(3) The enterprise culture integration after merger is very difficult. Many researches found that the differences of enterprise culture are the main reasons to induce failures of merger. The enterprise culture is a sort of important soft resource for the enterprise, and a sort of value view and action criterion formed in long-term production and management practice, and both parties of merger have inevitability to enterprise culture integration. However, because enterprise culture possesses speciality and stability, both parties always can not accept other's enterprise culture. When the enterprise cultures of both parties can not be integrated effectively, whether on individual layer or organizational layer, conflicts will occur and friction costs will increase.

2.4 Experimental material

Generally speaking, the core competition of enterprise is a suit of special skill and technology that the enterprise provides additive values to consumers, which has characters that cannot be simulated, cannot be replaced and cannot flow. The cooperative effect after merger can produce special skill and technology to enhance the core competition of the enterprise. But after merger, if both parties can not implement effective integration in aspects such as management, culture and so on, the motivation to enhance the core competition likely become a fine desire. Furthermore, with rapid increases of enterprise scale after merger, the enterprise market share enhances largely, and the enterprise may face risks coming from anti-monopolization of the government.

3. Experimental material and parameter enactment

From above analysis, at least we can obtain following two revelations.

First, the merger is a very complex work. Good merger motivation can not always bring good merger effect.

Second, though the merger is the main approach for the growth of the enterprise, but the risk of the merger is very high. Whether adopting merger or not, especially when facing domestic or international merger waves, enterprise must be serious, and can not blindly adopt merger measures only for going with the times.

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