The theory of mergers and divestitures

The theory of mergers and divestitures is developed in this paper. This theory is not dependent on taxes or the acquirer having huge surpluses. The inability of short horizon projects or firms which are marginally profitable to finance themselves as independent entities due to problems caused by agency between managers and potential claim holders is given as the motivation behind mergers. Good performance of the once marginally profitable projects allows for divestiture in the future. There exist two preconditions for this theory to be applicable. One that financial distress must be being experienced by one of the merging firms and the other that there must be severe agency problems between the mangers and the claimholders of the distressed firm. Therefore this theory is more applicable to mergers where one of the merging firms is facing cash flow verifiability and is small in size.

The fact that positive net present value projects may be denied funding where the cash flows can be manipulated by the management is well known. Marginally profitable companies are sometimes unable to support outside equity since the manager's incentive constraint requires that he/she receives a cut of project's cash flow. Thus a merger can serve as a tool whereby such firms can survive their distressed period as merged entity can raise total finance easier than a standalone entity. Shareholder value is increased according to the authors' theory and empirical evidence as mergers allow marginally profitable firms to get funding. However this financial synergy may not persist. Once the project has reached a stage where it can raise finance on its own there are coordination costs associated with mergers. This stems the firms to divest. This paper measures vertical relation between two merging firms using industry commodity flows information in input output table. A merger is classified as a vertical merger when one firm can utilize others' services or product as input for its final output or its output is the input for the other firm. Significant positive wealth effect is generated through vertical mergers. During the 3 day event window surrounding the announcement of mergers, the average combined wealth effect is about 2.5%. The paper measures the vertical relatedness by using an interindustry vertical relatedness coefficient. The merger is classified as a vertical merger if the coefficient is more than 1% (lenient criteria) or 5% (strict criteria). Further, those firms which exhibit vertical relatedness with the lenient criteria (1%) and belong to different input-output industries are identified as Pure vertical mergers by the author. To measure the wealth effect of mergers the authors uses CRSP value weighted index as market proxy.