

MOTIVES FOR COMBINATIONS OF TRADING COMPANIES

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Abstract

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The subject of this paper is an analysis of the development of activities at the European as well as the Asian market of foreign direct investments (FDI) and mergers and acquisitions (M & A). Causes of mergers and acquisitions and their development mainly in the period after the financial and economic world crisis are examined. A partial study focused on the merger market in the Czech Republic. The analysis results show that FDI inward dominate in the Asian market in contrast to more developed European and American markets where prevail FDI outward. The motivations for the activities in M & A markets are changed in dependence on the development tendencies of the world economy, politics, continuing liberalization of investment regimes, and implementation of the internationalization strategy on a large scale. The results of our study confirmed the hypothesis, that the main motive was the attainment of microeconomic advantages of the merging entities.

Keywords: company transformations, development of mergers and acquisitions, foreign direct investments, motives for M & A, synergic effect, value for owners

INTRODUCTION

Transformations of trading companies are closely related to the transformation of national economies into a global economy. Globalization has been in progress for over a thousand years, if we take into account the first trades between Europe and Asia (China); however, in contrast to the present-day globalization, these were largely time-consuming and highly risky economic relationships. The present economy is characterized by the dynamism of changes as regards both the volumes and the speed of capital transfers into the places where higher profits, better conditions for trading, cheaper workforce, etc. can be gained. When searching for possible higher added value, capital has essentially crossed the borders, enforced an unprecedented liberalization of monetary, financial, trading, goods and other flows, and we can also say, got rid of national sentiments. Globalization processes have accelerated and deepened recently. The international scale of economic activities has become commonplace, also because we can hardly delimit what is international or global, and we expect that our economic activities

will bring us face to face with partners from other countries of Europe or even other continents. From the economic point of view, globalization is mainly reflected in the increasing significance of knowledge, increase in the numbers of mergers and acquisitions (M & A), concentration of foreign direct investments (FDI), the increasing significance of multinational companies, and by contrast, the decreasing independence of smaller countries and the increasing dependence of economies on foreign trade.

This study concentrates on the causes of transformations of trading companies in the form of mergers and acquisitions. The historical development of trading companies at each moment is accompanied by their transformations, which are implemented with the purpose of stabilizing their financial position and increasing their financial performance. The final aim of the transformations, M & A as well, is the attainment of a higher economic benefit for their owners.

Transformations can happen in the form of internal (organic) growth of a business, such as reinvestments of incomes, building of new plants,

implementation of advanced technologies, or they can be of an external character when the business combines with another or is divided into more businesses. The reason is mainly the assumption (Cassiman and Colombo, 2006) that transformations bring a potential to improve in comparison with the current situation and that the resulting form of the company will be stronger, more efficient and will use its advantages in available markets. By combining companies, a concentration of capital occurs accompanied by the creation of a stronger economic group, the ownership structure changes, new organization systems are created and developed as well as various projects in personnel policy, a global company culture and philosophy is born (Wirtz, 2003).

Studies dealing with analyses of the development in the M&A market are predominantly based on global database systems, such as Mergerstat or Thomson Reuters, which largely contain data on combinations of enterprises traded in public markets. To measure activities in the M&A market these studies use time series reflecting the number of company combinations implemented in the investigated period and the value of the total equity entering a combination. Markets usually do not distinguish between acquisitions and mergers, which are then considered synonymic. An agreement on a combination of two or more enterprises into one, which thus gains more advantages than if the companies did business separately, is usually referred to as a merger. According to West's Encyclopedia of American Law (2011) is a merger or acquisition a combination of two companies where one corporation is completely absorbed by another corporation. The less important company loses its identity and becomes part of the more important corporation, which retains its identity. A merger extinguishes the merged corporation, and the surviving corporation assumes all the rights, privileges, and liabilities of the merged corporation. A merger is not the same as a consolidation, in which two corporations lose their separate identities and unite to form a completely new corporation.

The Czech trade law defines a merger as a combination in which one or more companies cease to exist without liquidation and their equity, including rights and duties following from labour-law relations, are transferred to another existing or a newly established successor company. It means this is a legal combination which requires an agreement of all participating companies. On the other hand, an acquisition is a transaction in which one company (the bidder) gains a decisive share of the basic equity of another (target) business. The acquisition can have a character of a capital investment (capital acquisition) or a property acquisition, in which the entire company or its part is purchased. By this a group of companies

connected by their capital arises and the legal position of individual companies does not change. Unless this is a hostile takeover, also a legal takeover can take place in case of property acquisition or capital acquisition by one owner. The differences between mergers and acquisition will mainly stand out in accounting procedures (Bohušová, Svoboda, 2011; Gláserová, 2013). Similarly, the European law (Directive 2005/56/EC of the European Parliament and of the Council of 26 October 2005 on cross-border mergers of limited liability companies) defines a merger as a process in which one or more companies, on being dissolved without liquidation, transfer all their assets and liabilities to another existing or a new company, in exchange for the issue of securities or shares representing the capital of the successor company and, if applicable, a cash payment not exceeding 10% of the nominal value of those securities or shares.

In agreement with the global shifting of capital, cross-border or even global M&A have started to prevail over the local ones starting from some development stage, and this has led to the creation of multinational corporations. They thus gain a form of FDI, not speaking about investments in the greenfields. If company combinations (M&A) affect the country's economy, macroeconomic changes affect company strategies based on the external growth, i.e. activities in the M&A market, to the same extent.

The aims of this paper are to analyse the M&A development in Europe and Asia, identify motives for mergers, and indicate possible preferences in the near future.

MATERIALS AND METHODS

The first references to mergers and acquisitions were observed at the end of the 19th century, when in the USA there was a need for larger investments in business and an effort to stabilize the position of some enterprises in the market. The study into the historical development of company combinations, has proven that activities in the M&A market did not happen evenly but they fluctuated in dependence on the level of the economic environment, the development of financial markets and mainly the ideas of bidders and target businesses about the price of a takeover. Some authors in this respect use the term merger and acquisition waves – these waves come at a certain level of development of an economy. E.g. Levy and Samat (1999) talk about 3 waves, Bobenic-Hintos (2009) mention 4 waves, Bruner (2004) divides the fourth wave into two: a) and b), Martynova and Rennebook (2008) differentiate 5 waves, Gaughan (2011) identifies 6 waves, Lipton (2006) identifies also 6 waves of mergers and acquisitions that represent a considerable deviation from the gradually growing trend of global mergers and acquisitions:

Wave 1: 1893–1904

The first wave was characterized by horizontal combinations of companies, in which companies in the same fields of business merged. Their purpose was to reach a higher share in the market and the effort to monopolize the fields (raw material extraction, metallurgy, engineering, transport, car production and telecommunication). The wave started to drop when antitrust regulations became effective.

Wave 2: 1919–1929

In the second wave vertical combinations took hold, through which a bidder expands the company backwards, back to the sources of raw material, or forwards, towards the consumer. Due to the tightening of antitrust regulations, the interest shifted towards oligopolies. The wave coincided with the boom in US stock market prices and ended with the Wall Street Crash and the following economic recession.

Wave 3: 1955–1969 (1973)

This period is characterized by the creation of conglomerates, which are formed by companies with activities in non-related fields. Entering new business fields was supported by the stronger US economy and bullish trends (bull market). The end of the wave was affected by the decline of conglomerates and the non-existent contributions expected from the diversification.

Wave 4: 1974–1980 (1989)

In the fourth wave, the decline of conglomerates continued and most of the implemented acquisitions had a character of a hostile takeover bid. Companies were purchased through financing by debt – leveraged buy-out – which brought about an increase in trades in markets with junk bonds. The target businesses used newly developed tactics to defend against the hostile takeovers. This wave penetrated the European market as late as at the end of 1980s in the form of cross-border horizontal mergers and acquisitions. Also speculators in stock markets profited from the business combinations as they were able to profit even if the mergers were finally not successful.

Wave 5: 1993–2000

In the 1990s managers' and owners' conviction predominated that expansion of a company will strengthen its competitiveness and stability. Companies started to consider possible advantages of company combinations and stock markets and mergers expanded again. Strengthening of operations and obtaining new technologies was mainly manifested in industrial fields, telecommunications, media and entertainment sectors. Growth was also manifested in international acquisitions and mergers. The fifth wave ended

when the internet bubble burst and big business financial scandals came.

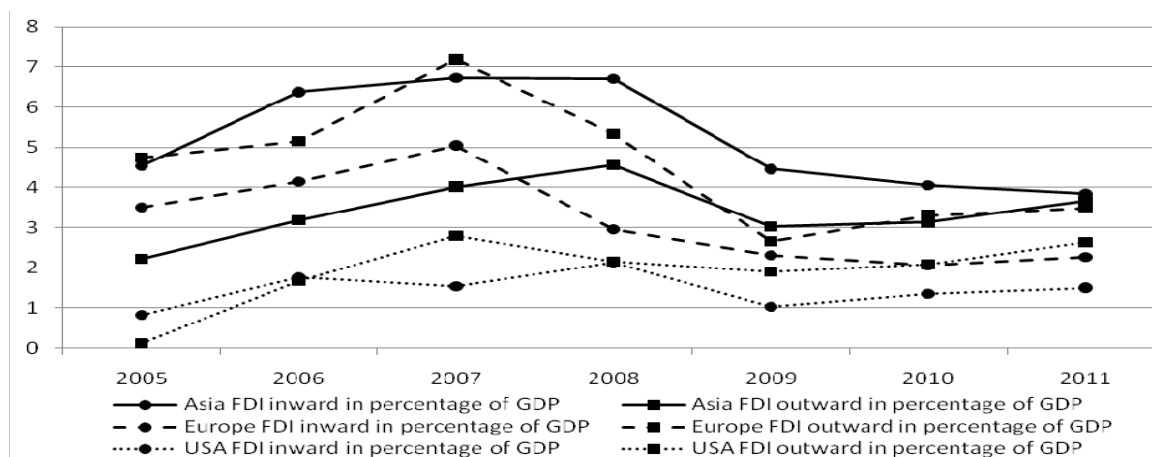
Wave 6: 2003–2006

The impulse for the sixth and for now last wave was globalization, support from governments of some countries (e.g. France, Italy and Russia) to create strong national or global champions, the rise in commodity prices, availability of low-interest financing, hedge funds and other stockholders' activities. The huge growth of private capital funds was accompanied by an increase in purchases initiated by managers. The burst of real estate bubble in the USA and the beginning of the global mortgage and credit crisis can be considered the end of this wave (Bank of America, 2007).

It seems that the length of M&A waves is shortening; however, another wave could hardly follow the sixth wave immediately, especially because this period was affected by a financial crisis, which then grew into the global economic crisis (2007–2009). Just like studies of top auditing companies and economic institutes (more closely e.g. IMAA, 2011), our previous research (Sedláček *et al.*, 2011; Hýblová *et al.*, 2012) also proved a strong correlation between the development of the world economy in recent years and the volume and number of activities in M&A markets. M&A activities gain in the times of economic prosperity and are diminished in the times of depression or stagnation. According to a study by The Boston Consulting Group of 2012, the cyclic character of M&A is related to the prices of assets, which induce a higher demand even for M&A in the stock exchange in the periods of a long-term price growth. Price growth in financial markets is usually related to a period when all economy grows. Investors also respond to government incentives, attractiveness of target countries, and the level of risk. To facilitate investors' decisions to enter new markets, several evaluation systems have been created, e.g. The Cass MARC Maturity Index (Cass Business School, 2010). Investors' attention has been recently directed to fast developing economies in Europe and Asia. The development trends of FDI inflow in both these territories are illustrated by the curves in Fig. 1.

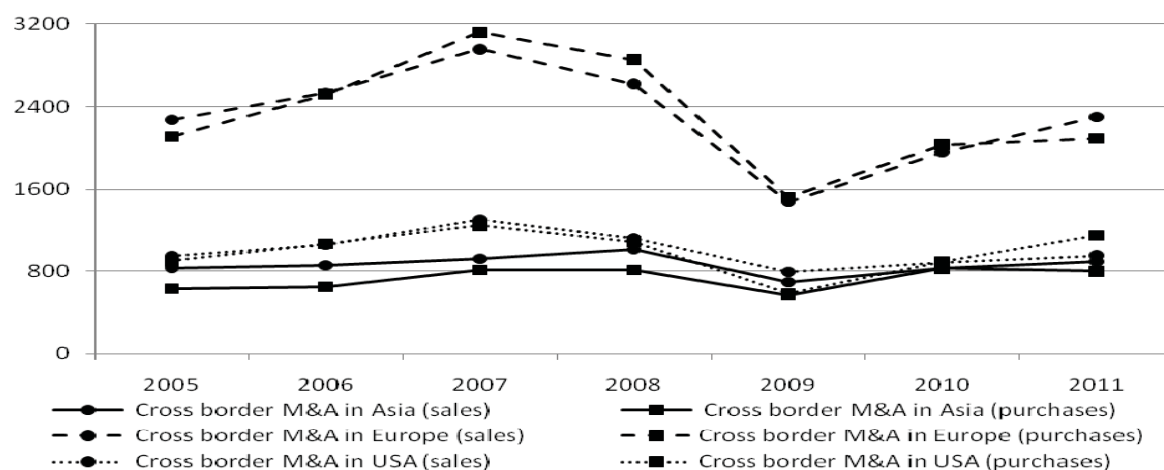
Fig. 1 shows that the highest inflow of FDI and cross-border M&A is in Asia, probably thanks to the fast developing economies of China, Indonesia, India and other countries, and also thanks to the low cost of workforce. In contrast to more developed European and US economies, capital inflow prevails over an outflow. All curves respond by a decrease in the period of economic crisis 2008–2009 but slightly increase in the following period.

Concerning the numbers of transactions in M&A markets, a similar trend is confirmed as in the case of volumes of implemented transactions related to GDP. The largest number of trades is implemented in European M&A markets, although purchases of target entities in other countries (including the European ones) are not as dominant



1: Development of FDI in percentage of GDP in Asia, Europe and USA (2005–2011)

Source: UNCTAD (2012)



2: Development of number of deals on the M&A market in Asia, Europe and USA (2005–2011)

Source: UNCTAD (2012)

as it was the case of FDI. As expected, the lowest activities are recorded in Asian markets, where the character of target entities prevails as they are purchased by foreign entities, mainly from other continents; however, the differences between the numbers of purchase and sale transactions are not so considerable and they even do not appear in some years. The development curves of activities in M&A markets provided in Fig. 2 again respond by a decrease in the number of trades implemented during the economic crisis, mainly in the European market. Markets in the USA and Asia seem thus to be more stable.

A merger or an acquisition mean that a trading company gets rid of a part of its capital, which could be otherwise used for its own (organic) development, in order to purchase another company. Therefore, the management may not be always in favour of mergers or acquisitions. Moreover, this process brings an element of instability into an existing organization, as it is necessary to implement new relationships, technological and production processes, organizational culture and management

methods. On the other hand, M&A are attractive because the established aims can be achieved quickly in comparison to a situation when the company starts building e.g. new production facilities in a greenfield. Possible motives for M&A are mainly the expected microeconomic advantages of the merged entities. Based on the way of reaching the advantages of merging, we distinguish strategic, financial and personal motives (Wirtz, 2003).

Strategic motives are mainly the efforts to achieve synergic effects, mathematically described by relationship

$$S = PV_{AB} - (PV_A + PV_B). \quad (1)$$

Expense for a merger is calculated as:

$$C = PP_B - PV_B. \quad (2)$$

The net current value for owners of the successor company is then:

$$NPV = S - C = PV_{AB} - (PV_A + PV_B) - (PP_B - PV_B) = PV_{AB} - PP_B - PV_A, \quad (3)$$

where

Ssynergy,

PV_{AB}the current value of the business after combination,

PV_Athe current value of business A as an independent unit,

PV_Bthe current value of business B as an independent unit,

Cmerger expenses,

PP_Bthe purchase price paid for business B,

NPVthe net current value following from the merger for owners of the successor company.

The synergic effect will be created by acquirers if they use a comparative advantage other businesses do not have and the management of the target firm itself is not able to use. The synergy from the combination will be usually manifested in the future by achieving higher returns, margins, better use of resources, lower expenses, etc. Moreover, the NPV has to reflect all risks which could threaten the economic gain for owners of the successor company or even turn it to a loss. Trautwein (1990) puts synergic effects in the first place among theories motivating M & A:

1. Efficiency theory, which is based on a synergic effect in the form of net profit.
2. Monopoly theory, which represents the achievement of a higher market power and leads to the transfer of wealth from customers.
3. Raider theory, according to which wealth is obtained from stockholders of the target business.
4. Valuation theory, which sees an information asymmetry as managers' advantage in negotiating the purchase price of the target business.
5. Empire-building theory, according to which managers maximize their utility at the expense of the shareholders' value. This approach has its roots in the separation of ownership from control in a company and the underlying idea is discussed in managerial theories of the firm.
6. Process theory considers the actual M & A process to be of key significance for decision making which is not always completely rational. Cognitive simplification and other process factors can as a consequence affect mergers and acquisitions positively.
7. Disturbance theory considers mergers and acquisitions to be a macroeconomic phenomenon. According to this theory, activities in the M & A field are influenced by disturbances in economy.

Brealey *et al.* (2006) consider the synergic effect a sensible motive for M & A and distinguish economies of scale and economies of scope. The economies of scale arise by the distribution of fixed costs into a larger scale of production, which brings a decrease in the costs per a unit of production, while the economies of scope or of activity combination arise, according to Denzel

(2004), due to the concentration and usage of input factors for the production of a broader range of goods. A withdrawal of some operations from the market and their redirecting inside the combined company leads to an elimination of many 'transaction costs' (material, information costs, costs related to negotiations and acceptance of various external trade decisions).

According to Kislingerová (2010), strategic motives include the achievement of a higher market share and thus also a higher market power of the company, which makes the obstacles for potential competitors' entrance in the market greater. Another motive for M & A is often saving of time, as by combination and concentration of capacities products or services can be offered faster or higher quality can be achieved leading to a higher price if the supply meets the demand in the market. An increase in prices and a decrease in the consumers' welfare can even come before the actual implementation of M & A, as a consequence of a merger being announced. The market synergy can have a form of production diversification, meaning a smaller dependence of the total profit and loss account of a concentrated entity on one product or field. This is an application of the risk portfolio and optimization of the long-term distribution and management of the business risk (Bejček, 2010). Picot (2008) considers an increase in competitiveness, especially on an international scale, to be a strategic motive. The merging of complementary sources or the concentration of knowledge is conducted with the purpose of gaining a company that is unique at something, e.g. has handled product innovation, technology, skill or knowledge, but has no financial sources and ability to use its advantages in the market. This can be a connection of patent or otherwise protected research and development directions of former competitors, which will enable a creation of new products and technologies formerly prevented by legal impediments. A motive can also be a pathological effort to gain a competitor's company and close it.

Often mentioned examples of financial motives are the tax optimization using a tax loss of the purchased company, an increase in earnings per share if the gained company has a lower indicator than the acquiring company, gaining of financial sources with an easier access to capital market (increase in the company's credibility and thus attractiveness of its shares), or the motive of liquidation value in the cases when the liquidation value of a company is higher than its yield value (Nerudová, 2011).

Personal motives include the syndrome (hypothesis) of having eyes bigger than the stomach (managers purchase competitors in the effort to be larger without proper calculations), managerial hypothesis saying that the prestige and power of managers depend on the size and growth of the company they manage, managers' protection against hostile takeovers (if there are undistributed

funds in the company), management's belief in their ability to use the acquired company's potential better, in their more effective management than the former managers were capable of.

The above mentioned motives can be considered motives of the successor companies; the motives of the acquired companies are of opposite character. They can be a lack of means for growth investments or to settle a debt, decreasing of capital costs, winning access to the capital market, gaining tax advantages, insufficient size of company, new strategic business orientation, an extremely important partner or top experts leaving, a radical solution of owners' disputes, a professional rise, a more suitable alternative of investments than internal investments, etc.

The fact that activities in M&A markets do not develop uniformly but in waves proves that transactions are related to the changing economic environment, which thus becomes the main motivating factor for M&A. Companies contemplate whether the organic growth is sufficient for an adequate response to new challenges and possibilities, whether they are able to reach new markets, gain new technologies or a higher credit of the brand. A reason for the external form of growth can be mainly inaccuracy of some production processes (e.g. the workforce or the materials), effort to approach the end consumer, gain deeper understanding of clients' needs, minimize transport costs, etc.

RESULTS AND DISCUSSION

As has been mentioned, there are a number of possible motives for M&A, either strategic or financial; however, the final consequence of these transactions should be an increase in value for owners. The published studies indicate that they are usually strategic investments and their number depends on the development degree of the economy

and the situation in the market. E.g. Ogden (2002) established the order of motives as follows:

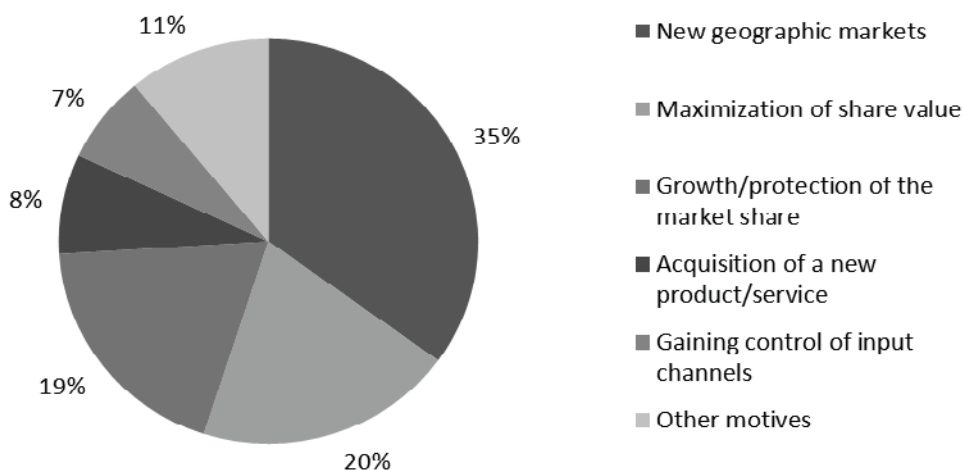
1. operational synergy,
2. financial synergy and diversification,
3. measure against bankruptcy,
4. lack of financial sources,
5. overvaluation of the target company as regards the added value in the future,
6. management's interests.

Results of research into motives conducted in 1996–1998, which positively affected the success rate of companies, were published by KPMG (2011). The research analysed a sample of 107 companies selected from TOP 700 international M&A based on the transaction value. The basic criterion of success was the value of shares. The percentages of the specific motives are provided in the graph, Fig. 3.

Similar research was performed by Towers Perrin (2009), which examined the influence of human factor on the M&A success. The survey included 404 respondents from 25 countries; the respondents were executive managers and personnel staff of companies that had implemented one or more transactions in the previous three years. The results are summarized in Tab. I.

Motivations for M&A in the Czech Republic were researched using a sample of mergers implemented in 2001–2012. The survey had a form of controlled interviews with employees of the executive management of the companies that had implemented one or more mergers. The aim of the survey was to find the motives for mergers (excluding acquisitions), whether they were strategic and not financial. The actual process was mainly affected by the accounting method of the merger – partners preferred the method of combining shares to the method of purchase. The survey included 59 respondents, who mentioned motives in the proportions as shown in Tab. II.

Motives for M&A are largely affected by the direction of capital flow. The Czech territory is



3: The percentages of motives for M&A (KPMG)
Source: KPMG (2011)

I: *Motives leading to M & A (Towers Perrin)*

Motive for transaction	%	Motive for transaction	%
Expansion of products/services	33	Acquisition of hired property	3
Geographic expansion	20	Expansion of company assets	
Response to competition/field	16	Diversification	
Maximization of the scope	10	Access to classified information	
Organizational transformation	6	Provision for project development	
Acquisition of technologies	6	Financial investment	
Optimization of costs	3	Location of business activity	
Acquisition of talents/abilities	3	New business	
Strategic development plan	3	Leading position in the region	

Source: Towers Perrin (2009)

II: *Percentages of motives for mergers in the Czech Republic (MU ESF)*

Motive for transaction	%	Motive for transaction	%
Administration simplification	22.50	Expansion of production portfolio	3.75
Tax optimization	12.50	Diversification	3.75
Operational synergy	11.25	Prevention of competition	3.75
Unification of control structures	7.50	Protection of fixed assets	5.00
Stronger market position, new markets	7.50	Economies of scope	5.00
Simplification of ownership relations	6.25	Investment opportunities	2.50
Better access to loans	6.25	End of activities of the target company	2.50

Source: authors' database

dominated by local transactions but the proportion of cross-border M & A has been rising like in other European and Asian countries in dependence on the country's attractiveness for investors. There are developed countries in both the regions, which are considered less risky by investors due to their political stability, economic freedom, mature financial markets, technologies, legal systems and the high socio-cultural level. Larger risks are faced when investors enter transitive or developing economies. Great motivations for activities in M & A markets are the stable world economic growth, continuing liberalization in investment regimes and implementation of the internationalization strategy on a large scale, as is documented by the rising number of multinational corporations. Pro-growth factors are mainly reforms that increase the long-term competitiveness of host countries, agencies promoting investments, policies focused on the maintenance of the current activities, creation of conditions favourable for business and the investment climate, and mitigation of protective tendencies. In the financial field, these are low interest rates, strong reserves of corporate and private capital in cash and availability of target companies for acceptable prices.

On the other hand, slowing-down factors are political and economic insecurity in the form of the Eurozone crisis, slowing down of the economic growth in China, and doubts about the force

of US economy. This experience together with the continuing insecurity in global markets of commodities has won over the strengthening of the economic basis.

According to surveys conducted by Allen & Overy (2012), foreign investors' interests regarding M & A markets have started focusing on China and India, which are becoming big players, even in the position of the acquirers, see Tab. III.

Similar results have been published by R. R. Donnelley & Sons, concerning developing M & A markets (VENUE Spotlight Market, 2013) – increase in activities in developed and developing countries is expected. The respondents consider multinational corporations to be the main acquirers. In their opinion, the companies from developing markets will be coming forward in other growth M & A markets and will gain well-established companies in an unprecedented rate. Especially China and India focus on other developing markets with the aim to increase their market shares and achieve global diversification. By contrast, multinational corporations from developed markets are quite strongly interested in growth in developing markets. They have enough capital as well as access to cheap financing and are prepared to invest in attractive assets. An increase in customers' demand, new markets and strong sources are still motives for cross-border M & A.

III: Outbound and inbound M&A ordered by the value of transactions in USDm (Q4 2012)

Outbound merger and acquisitions				Inbound target markets		
Rank	Country	Value of deals	Volume of deals	Country	Value of deals	Volume of deals
1.	USA	167 424	228	USA	179 937	162
2.	Japan	103 515	80	UK	86 092	108
3.	UK	64 463	88	Canada	56 769	50
4.	Canada	40 636	61	Germany	32 503	51
5.	Germany	39 408	43	Netherlands	32 122	22
6.	China	37 923	49	Singapore	25 379	19
7.	Hong Kong	35 315	35	Australia	24 321	42
8.	France	34 153	36	China	24 260	36
9.	Switzerland	31 358	26	Brazil	23 004	37
10.	Thailand	26 863	10	France	16 401	31
11.	Netherlands	24 019	25	Italy	17 384	22
12.	Singapore	16 452	21	India	14 850	21
13.	Russia	10 655	11	Switzerland	11 038	16
14.	India	9 616	10	Japan	11 616	13
15.	Australia	7 654	14	Hong Kong	10 125	20
16.	Malaysia	7 564	12	Spain	6 139	18
17.	Sweden	7 015	20	Denmark	5 792	13
18.	South Korea	6 710	13	Norway	4 905	14
19.	South Africa	5 092	12	Belgium	4 905	14
20.	Luxembourg	4 063	12	Poland	4 863	12

Source: Allen & Overy (2012)

CONCLUSION

The conducted analyses of the historical development of activities in M&A markets confirmed a recent revival in both examined territories in the period after the financial and economic crisis. From the perspective of location of transactions, local M&A prevail over the foreign ones. European and Asian markets have recorded investors' interests (of multinational corporations) from developed as well as developing economies. A high increase in activities in the near future is expected for the developing markets in the position of acquirers as well as target companies mainly in China and India.

In contrast to Trautwein's theories, a more recent study names expansion of products and services to new geographical markets as the main motives for M&A. This confirms the hypothesis about the strengthening of cross-border activities at the expense of the local ones – see besides other results the analysis conducted in the Czech merger market (Sedláček *et al.*, 2011).

The analysis of a sample of selected mergers implemented in the Czech market in 2001–2012 showed that the main motives were simplified administration and tax optimization, which led to cost savings. The combinations of companies that were interconnected by capital or had the same owner prevailed. Although these motives are not declared as ways leading to the increase in value of the acquiring company, we are convinced that in the end, mergers and acquisitions, if successful, will bring a higher wealth for owners.

Although we cannot predict another M&A wave, we can say for certain that they are related closely to a stable global economic growth, continuing liberalization in investment policy, implementation of the internationalization strategy on a large scale, and reform processes leading to the creation of conditions favourable for business and investments.

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