If Merger Is the Answer, What Is the Question?
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After working on hundreds of merger investigations as a government antitrust enforcer, it's clear from reading internal documents that mergers are thought to cure a variety of corporate ailments, including, but not limited to: under-diversification, high taxes, excessive overhead, limited product offerings, under-investment in R&D, and my personal favorite, ruinous competition. All that is missing is the disclaimer that the FTC requires on testimonial ads: "results may differ."

In some mergers the value created is obvious and well documented, but for a surprising number the analysis is nothing more than a litany of excuses copied out of a corporate strategy textbook to justify the deal to the board of directors. If the firm were a fraternity, the junior M.B.A. student assigned to write the memo would be a pledge, and the memo would be part of the hazing ritual designed to build what academics like to call "a common sense of identity." The message is that you look for problems only after deciding on the solution.

This kind of cart-before-the-horse analysis causes several problems, the most immediate being if one of the items on the list is "to eliminate a close competitor." Since these documents are all discoverable in a merger investigation, the analysis becomes a smoking gun that obligates the antitrust enforcement agencies to deepen and widen the investigation. This raises the costs of regulatory compliance in addition to the costs associated with delay, uncertainty, and attrition. If my colleagues who study organizational behavior could figure out how to make the bad employees leave, mergers would easily pay for themselves. But until that happens, attrition falls on the other side of the ledger.

The merging parties' response to these damaging documents is so common that it has a name - the "brain-damaged, middle-management defense." That it often works is due to the low expectations - formed by decades of reading company documents - government officials have for this kind of analysis. And if the enforcement agencies don't believe the internal analysis, the merging parties will find it difficult to put up an efficiency defense to an otherwise anticompetitive merger.

The other, more terrifying problem caused by this kind of analysis concerns the fiduciary duty of the board of directors. The problem-whose-name-cannot-be-spoken can arise when a merger announcement moves stock price the wrong way and can be defended only by claiming the decision was made by exercising business judgment. Even with the deference given to management by the courts, it might be hard to hide behind a memo written by brain-damaged middle management.

So what to do when considering a merger?

The obvious answer is to use your business judgment. Solve problems by first figuring out what's wrong and then choosing the best available solution. For example, if your price is too high because it costs too much to purchase a crucial input, figure out why. If the high price is caused by the "double markup" problem (two independent producers marking up their products without considering the effect that their prices have on each other's demand), then merger or acquisition can solve the problem by bringing pricing authority under common management. Turn the upstream producer into a cost center and transfer the product at marginal cost to the downstream division.

There are a host of good reasons to acquire another company, but acquiring a company simply because it's profitable or has a large share is not one of them. Profit or share is worth just as much to the target company's shareholders as it is to yours. And unless the target is worth more to the buyer than it is to the seller, there is no reason to transact. If you have a good reason to buy, identify it and document it before you buy. Not only will this lead to better decisions, but it also might help you avoid legal problems.

The movement of assets to higher-valued uses is the wealth-creating engine of capitalism. Our biggest, and most valuable, assets are corporations. That we cannot document for many mergers a good reason for their movement, is a stain on our corporate reputation.

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