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Section C: The Economic Theory

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The business world is defined by numerous profit-oriented firms and organizations that compete for a scarce market. Two or more related competitive firms may choose to merge in conducting business, creating a large and competitively advantaged new firm. This process yields a merger, defined as an agreement that unifies two companies to form a new company (Becker, 2017). For example, the two British pharmaceutical corporations, Glaxo Wellcome and SmithKline Beecham amalgamated in the year 2000 to form the re-known GlaxoSmithKline pharmaceutical firm. One and only theory important in deciding on business mergers is the economic theory. This theory simplifies complex real-world economic issues to enable analysts to discover the most effective solution. It uses different ideas and principles to expound on the working of economies. The purpose of the theory is to Investigate the viability of a merger. The economic theory suggests the consideration of two effects. These are the market valuation of assets of the combined firms and the treatment of buyer power.

Question One

The market value of assets is a critical aspect to examine when dealing with a possible merger case thoroughly. This term entails the price an asset would achieve in the market if it were to be sold (Becker, 2017). Due to the delicateness of mergers, property advice is crucial at the strategic level of portfolio reviews and the operational level. The advice is concerned with space planning, efficiency evaluation, and allocation. Company property ranging from land, buildings, vehicles, and others form a critical factor in most business decisions since it has unique traits of being a major input into production exercises. The market value of both assets may play a key role in determining whether a merger is possible or not. The merging process must value each company's assets in line with the current market prices to obtain the total monetary strength produced by these assets. In calculating the firm's net possessions, statement of financial position of the firm's is used to identify tangible and intangible assets. A deduction of intangible assets from the total firm's assets is made in determining total tangible assets. Again, total liabilities are subtracted from the resulting value to achieve the net asset value. Applying the market value method dictates that the asset value on its market price or expected price be considered if sold in the open market. When similar assets are absent in the market, the replacement valuation approach is used.

The treatment of buyer power in merger cases involves the valuation of buyers and sellers (Palepu et al. 2020). This valuation may differ from the outcome that each merging company expects to gain by the transaction, although none predicts an increase in value from the merger. The expected gain to the merging firm is called the shareholder value added (SVA). SVA explains the disparity between the estimated value of synergies achieved from mergers and the merger premium. The three common ways to establish whether mergers increase value are as follows. The first method uses the short-run stock performance of the merging firms or the combined entity surrounding the merger. This method is assumed to be most efficient to show value creation because stock prices easily align with new information and incorporate any projected changes from the merger. Secondly, the long-run performance of the merging firm for three to five years after the merger is announced can be used. This method has a challenge if the merger underperforms in the first years of operation due to incompatibility of employees from merging firms. The accounting measure of profitability is used to measure value creation by including return on equity or assets. If the merger creates value to shareholders, then the new firm's performance and profitability improve.

Question Two

The economic theory may suggest the market value of assets or buyers' valuation in creating a merger (González-Torres et al., 2020). However, different circumstances influence the effect to be considered. There are different contexts and motives which call for asset values consideration in business merging. Firstly, size may be advantageous when related to cost. Here, size enlargement may help in improving profitability via cost lowering achieved from economies of scale, efficiency in operation, and synergy. In this case, merging firms may consider the assets market value projected to increase the size of the resulting merger when making merger decisions. According to González-Torres et al. (2020), the aspect of market value for assets may also be used when a firm with good profit history and established position in its line of the business wishes to reduce risks. Through mergers, risk diversification is achieved since these risks are shared between two firms. Thirdly, mergers may result in an increased value of the assets hence increasing the resultant market power. The increase of market power is achieved by creating monopolistic conditions that emerge from combining two firms. In cases where a merger is expected to increase the assets and consequently the market command significantly, the economic theory may suggest the market value of assets to be useful in advocating for the merger.

In other situations, the economic model may suggest that the valuation of buyers and sellers be used in merging two companies. According to Palepu et al. (2020), this occurs when neither of the merging firms expects an increase in the market value of assets due to the merger. When the two merging firms apply similar methods in valuing the buying and seller power, then the economic theory may suggest the treatment of buyer power to be applied in merging. Again, mergers may result in the dictation of the market prices of goods and services due to the buying power achieved. A merger may not be expected to increase the number and value of assets tremendously. However, merging firms may obtain control over the prevailing prices of commodities through the combination. In this case, firms may consider a merger based on the value of buyers and sellers. Additionally, for shifts in bargaining results emanating from buyer mergers to improve efficiency, post-merger parties must reach a more optimal price plan due to lowered transaction costs. Also, under special circumstances, strong buyers may have the ability to restrain price increment from a suppliers' merger. Empirical studies must be used to guide the analysis of this merger defense.

References

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