

# Research on Enterprises Vertical Merger Based on Transaction Cost Theory

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**Keywords:** transaction cost theory; vertical merger; enterprises merger

**Abstract:** Under the condition of market economy, with the continuous improvement of the socialization of production, the scale of enterprises also needs to expand. Vertical merger is an important phenomenon in the course of economic development. This paper gives the concept of transaction cost and makes an economic analysis of vertical merger from the perspective of transaction cost theory. This paper holds that the factors of asset specificity, uncertainty, transactions times and incentive mechanisms can influence the transaction cost of the enterprise vertical merger.

## 1. Introduction

Mergers have realized capital concentration through property rights transactions, enabling enterprises to gain economies of scale and enhance their own competitiveness. On the macro level, we optimized the allocation of resources, revitalizes the stock assets and promoted the upgrading of the industrial structure. The theory of transaction cost has its unique view in explaining the merge. In the fierce market competition, the way enterprises grow and expand can not only be accumulated through their own capital, but also can strengthen their own capital scale by merging other enterprises. The latter is more rapid and convenient than the former and can achieve leaping development. The enterprise merger and acquisition, generally taking the property of the enterprise as the trading object and taking the control of the merged enterprise as the purpose, is the inevitable result of the enterprise competition and the development of the industry. The vertical merger refers to the vertical integration of enterprises by acquiring the control rights of enterprises located in the upstream and downstream industries. It is an important strategic behavior in the process of enterprise development, and it is also the inevitable outcome of market competition. Vertical merger and acquisition of enterprises refers to the merger of enterprises with suppliers or customers, that is, the dominant enterprises will merge with the production and marketing enterprises closely related to this enterprise, to form the integration of vertical production. When merger and acquisition elements or raw material production enterprises are called post-merger mergers and acquisitions. When mergers and acquisitions eventually produce and sell enterprises, they are called forward mergers and acquisitions. From the micro level, the vertical merger and acquisition of enterprises can achieve more centralized capital through the form of property rights transactions and is also an important means to improve the competitiveness of enterprises themselves. From the macro level, vertical mergers and acquisitions can make resources more optimized, revitalize stock assets and promote further optimization and upgrading of regional industrial structure. At the same time, vertical mergers and acquisitions have led to increased business risk, loss of specialization and management costs, serious waste of resources, high cost of exit barriers. This paper attempts to conduct an economic analysis of vertical mergers and acquisitions from the perspective of transaction cost theory to explain the rationality of vertical mergers.

## 2. Concept of Transaction Cost

Trade is the exchange of value. Von Mises, the father of the Modern Austria School, proposed that trading is an attempt to replace dissatisfied situations with more satisfactory situations. It fully demonstrates the subjective intention and effect of the trader, but it is obviously too broad and not critical. Speaking from the subjective will, people hope that the passage of time can bring more

satisfactory situations. In the eyes of Commons, the transaction is not only the transfer of simple goods or services, but also the relationship between people. Transaction cost refers to the sum of all expenses arising from the integration and allocation of related resources. It includes the cost of information collection, the related communication between different organizations, the cost of negotiation, the cost of the negotiations between organizations and organizations, the drafting of the contract, the cost produced by the supervision, the third parties to make judgment on the breach of contract, the cost of arbitration and so on. If the market transaction costs are very high, the relevant managers of enterprises should try to deal with this problem, because the high transaction costs will undoubtedly increase the financial burden of the enterprises and prevent the development of other strategic plans of the enterprises. At the same time, managers within the enterprise should try to optimize and integrate the relevant transactions within the transaction, to reduce the cost of resource allocation in the process of this activity. We divide transaction costs into two parts: *ex ante* and *ex post*. Prior transaction costs refer to the cost of drafting contracts, negotiating the contents of contracts, and ensuring the fulfillment of contracts. The *ex post* transaction cost is the cost from changing the terms to the withdrawal of the contract when solving the problem of the contract itself, including the cost, the bargaining cost, the establishment and operation cost and the guarantee cost.

In the actual market behavior, with the quickening of the pace of the enterprise, the expansion of the target, and the expansion of the scale of the behavior, the cost of the enterprise will be more and more. When and how to conduct the conduct of the cost of control, the relevant management of the enterprise should be considered in advance, and to formulate relevant measures to deal with, only in this way to ensure and implement unexpected events in the execution, the enterprise can quickly and flexibly respond. Merger and acquisition is the transfer and merger of property rights. Fundamentally speaking, it is a redistribution of residual control rights. On the one hand, it brings benefits, and the merged enterprises increase the enthusiasm for the special assets by taking the residual control and increase the efficiency, because more residual control over it can share the greater part of the enterprise surplus; on the other hand, it brings the capital and the annexed enterprise is in the residual control. On the other hand, the weakness of the stock market decreases the enthusiasm for special assets investment, because less residual control means less part of the enterprise surplus. The cost of search in mergers and acquisitions includes the cost of information collection and evaluation of an enterprise's operation, management, finance, law and organizational system. Mergers and acquisitions need specialized personnel, and the intermediary structure has specialized talents, standardized procedures and long-term experience, which can provide information at lower cost. However, China's capital market and intermediaries are still underdeveloped. The two sides of the merger and acquisition are faced with information asymmetry. In the case of asymmetric information, the uncertainty of the two sides increases, which leads to the lengthy negotiation time, which is one of the reasons for the increase of the acquisition cost of Chinese enterprises' merger. The enterprise and the market are the different institutional arrangements of how to join the division of labor between different production processes. There are fundamental differences in the way of coordinating the division of labor. Therefore, the different transaction costs of organizing the transaction are shown. Whether mergers and acquisitions are economic depends on whether merger can bring about savings in transaction costs.

### **3. Economic Analysis of Transaction Cost of Enterprise Vertical Merger**

#### **3.1 Asset Specificity**

Asset specificity refers to the extent to which assets can be used for different purposes and by different users without sacrificing production value. It is related to the concept of sunk cost. After the merger and acquisition, the transfer and merger of property rights give more residual control over the annexed party, while the residual control of the annexed party is weakened. Therefore, for the annexed party, its special investment incentive is strengthened, while the annexed party is the opposite. Therefore, the size of the merger depends on the specific investment of which side is more important for the improvement of efficiency. From Grossman - Hart - Moore model we can know that

if Party A's investment ratio is more important than Party B, then a m Annex B is more efficient. In addition to the change in the incentive mechanism of special investment, special investment will give more load to the market trading mechanism. Specific investment makes the bilateral trading relationship more and more interdependent and increasingly close. Compared with the internal organizations, the power distribution of the trading subjects in the market is more equal, and the adjustment of the trading relationship depends on the two sides' consultative dialogue. However, the existence of differences and contradictions has caused obstacles to the rapid and effective reach of consensus between the two sides. Therefore, strengthening the degree of mutual dependence has become particularly difficult to adapt to the external interference, and it also brings about the rise in the cost of governance. But the internal organization of the enterprise is different. Because of the stronger control power, the enterprise can adjust the relationship between the two parties through the command and authority, and the adjustment of the contract is more adaptable. From this perspective, M & A has the advantage that the market cannot compare with the exclusive asset investment. When this asset specificity is high enough, the potential cost of market transactions will prevent enterprises from continuing to rely on the market. At this point, as a substitute for the market, vertical mergers and acquisitions have emerged.

### **3.2 Uncertainty**

For enterprises in a complex and changeable market, production and operation activities are facing many uncertainties. The object, price, demand, preference, time, power, responsibility, profit, distribution and commitment of market transactions are constantly changing. This change is undoubtedly increasing the risks faced by enterprises in production and operation, and at the same time, it also puts forward the adaptability requirements for market transactions. And enterprise merger and acquisition, through the transfer and merger of property rights, internal transactions, thus reducing the risk caused by the external environment interference, but also enhance its adaptability to the trading environment. Uncertainty includes the uncertainty of external conditions and the internal disturbance factors in the transaction, which is highlighted by the uncertainty of the behavior of both parties in the transaction process. This uncertainty will increase transaction costs for both parties with vertical buying and selling or cooperative relationship, which is manifested in increasing their choice of contracts. The cost. If we choose long-term cooperation, we will face two problems. The flexibility required by uncertainty is an important issue. If a long term contract is signed, both parties will lose the flexibility to adapt to market conditions and face the potential risks of uncertainty. In order to deal with the opportunistic behavior of the parties involved in the transaction, the two parties have to complicate the contract, which will inevitably increase the cost of reaching the contract. If we choose short-term contracts, we will face the double impact of opportunism. In this way, once a party in the transaction has opportunistic behavior that destroys the performance of the contract, the other will have to increase the cost of its search and wait for the competitors, and the possibility of the success of the contract negotiations is greatly reduced.

### **3.3 Transactions Times**

Mergers and acquisitions can increase or deprive market forces by increasing barriers to entry or allowing price discrimination against consumers. When most of the competitors in an industry adopt vertical merger and acquisition strategy, nonintegrated participants will be difficult to enter the industry because he must enter the competition at all stages of the industry, which will increase the cost of capital and the minimum effective size of operations, thereby increasing the barriers to entry. Trading frequency can affect the choice of transaction modes by affecting relative transaction costs. It is the main symbol to distinguish all kinds of transactions, and it is also an important feature of transaction cost economics and other theories explaining economic organizations. Because of asset specificity and uncertainty, vertical mergers and acquisitions can be used to ensure the stability and adjustability of contracts. But vertical mergers and acquisitions also increase transaction costs, because vertical mergers and acquisitions are also a kind of transaction, and there are also transaction costs, such as negotiation costs and performance costs. In the case of the given asset specificity and uncertainty, whether to adopt vertical merger or acquisition depends on whether the transaction costs

increased by vertical merger and acquisition will be compensated, which is determined by the number of transactions. If the number of transactions is low, that is, transactions do not happen frequently, it is difficult to get compensation for new transaction costs of mergers and acquisitions. If the transaction frequency is high, it means that the transaction is recurrent and repeatable, and the new transaction costs due to vertical mergers and acquisitions can be spread to many ongoing transactions, the relative cost can be reduced and more easily compensated. Therefore, when the cost of transaction costs is greater than the cost of enterprise management, vertical mergers and acquisitions will take place.

### **3.4 Incentive Mechanisms**

Any individual engaged in economic activities tries to obtain the greatest economic benefits at the lowest economic cost. In today's market economy, mutual win and mutual benefit are the foundation of cooperation. Incentive mechanism is crucial and is the key to vertical mergers and acquisitions. The ownership of an enterprise includes the controlling power of an enterprise and the claim for surplus value of an enterprise. The merger and acquisition of enterprises has changed the pattern of control and residual claims. Residual claim is extremely important. It is the most important element of incentive. For the enterprises, the loss of the residual claim brings the lack of incentive functions, such as the possibility of opportunism, such as laziness and concealment, which greatly increases the transaction cost. For the merger and acquisition enterprises, due to the acquisition of residual claims, their efforts, innovation, private asset investment and other activities have greatly improved, thus efficiency has been improved. Whether the merger or acquisition of an enterprise is to consider the transaction costs brought about by the increase of the opportunistic behavior of the annexed party, as well as the benefit obtained by strengthening the incentive mechanism of the annexation party. The implementation of the multi-level incentive mechanism is a secret incentive mechanism of enterprise success. It is a system that is always open. It is constantly changing with the changes of the times, the environment and the form of the market. This first shows that there are different incentive mechanisms in different periods, while paying more attention to the training of the spirit of collectivism and the basic satisfaction of material life and providing more space and benefits to the employees. Positive incentives and negative incentives are two different types of incentives. The purpose is to strengthen people's behavior. The difference lies in the opposite direction of the two. Positive motivation is the affirmation of behavior and plays the role of promoting and strengthening. Negative motivation is the negation of behavior and its inhibitory effect. An excellent manager must have the ability to promote the development of his career and lead the subordinates. It must learn to use art to stimulate the potential of his subordinates, improve their enthusiasm, initiative and creativity, and try to realize their organizational goals voluntarily.

### **4. Conclusion**

Vertical merger is essentially a form of contract that enterprises choose to save transaction costs. When vertical mergers and acquisitions can make management well-coordinated and improve the market competitiveness of enterprises, and reduce production costs and increase profits, it is achieved success. The enterprise will implement it if the cost that the enterprise uses internal management to configure the resource is greater than the cost produced by the market mechanism. It is a kind of coordination between management and market mechanism, and its goal is to save transaction costs.

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