MERGERS, DIVERSIFICATION AND FINANCIAL INTERMEDIATION

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Abstract:

This work presents an equilibrium model of diversification through merger formation. Due to moral hazard problems, poorly capitalized firms are credit rationed and may seek to alleviate the incentive problem (and thereby raise external funds) by either merging, employing a monitor or a combination of the two. Within this setting, the effects on merger activity of different kinds of capital tightening are studied. In particular, credit crunches, collateral squeezes and savings squeezes are analyzed. One of the main results is that conglomerate merger activity increases during times of economic expansion and is positively related to aggregate output. Furthermore, the model offers a rationale for diversification that is immune to the diversification neutrality result and furthermore explains why diversified companies trade at a discount relative to their non-diversified counterparts.