

Mergers & Acquisition Hurdles

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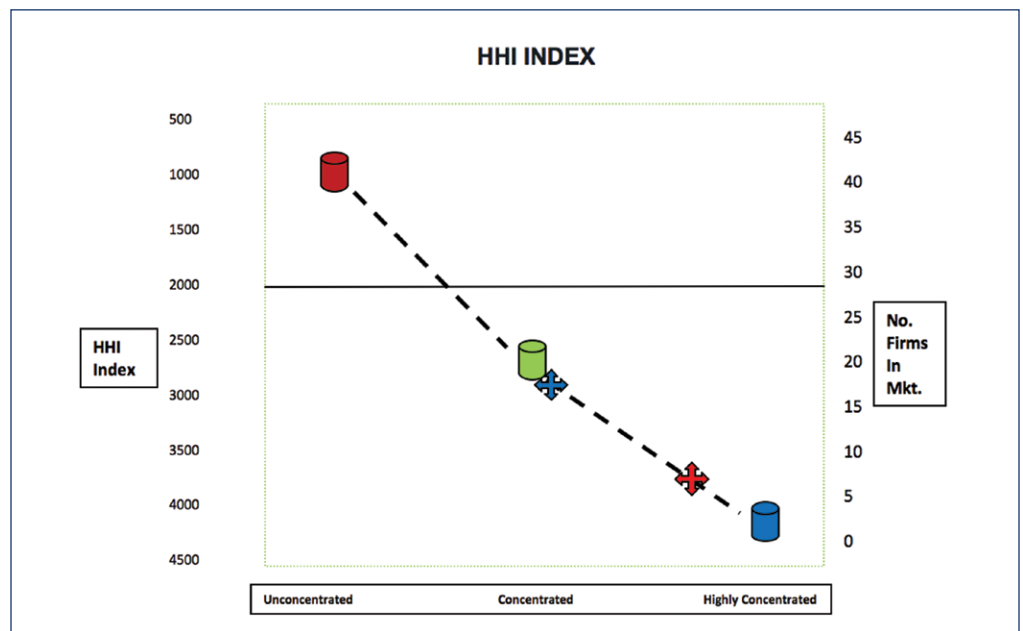
Joint ventures, mergers and acquisitions are many times, extra-ordinarily complicated disjointed and time consuming. We would not attempt to cover all of these M&A dynamics in a single column but we feel compelled to alert you to and define one very important “hurdle” the government uses when evaluating both public and privately held companies. A formula, once understood, could save a great deal of time upfront in M&A considerations.

Ever since the early eighties, the U.S. Department of Justice, the Federal Trade Commission, and state attorneys general have used a screening guide referred to as the Herfindahl-Hirschman Index (HHI) to measure market concentration for purposes of antitrust enforcement. This market index (HHI) is calculated by summing the squares of the percentage market shares held by the respective firms within a specific well-defined market space. For example, an industry consisting of three firms with market shares of 40%, 30% and 30% has an HHI of $40^2+30^2+30^2$, or 3400.

The HHI takes into account the relative size distribution of the firms in a market. It approaches zero when a market is occupied by a


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Company Name	Sales Bn \$	Merge	SOM%
XYZ	3.500	✓	28.8
ABC	3.120	✓	25.6
DEF	2.550		21.0
RST	2.000		16.4
Others	1.000		8.2



large number of firms of relatively equal size and reaches its maximum of 10,000 points when a market is controlled by a single firm. The HHI increases both as the number of firms in the market decreases and as the disparity in size between those firms increases.

Let's assume four coatings companies have the following SOM (Share-of-Market) in the very concentrated Automotive OEM market segment and the two largest (XYZ & ABC) decide to merge taking a total of 54.4% of the market in doing so.

The resultant HHI would be a prohibitively high figure of 3735 and calling very rigid attention from the FTC in the process. 

Even considering the two lowest SOM players (DEF & RST) at 21.0% and 16.4%, respectively, we find a higher than FTC acceptable figure of 2949. 

The agencies generally consider markets in which the HHI is between 1,500 and 2,500 points to be moderately concentrated, and consider markets in which the HHI is in excess of 2,500 points to be highly concentrated. Transactions that increase the HHI by more than 200 points in highly concentrated markets are presumed likely to enhance market power under the Horizontal Merger Guidelines issued by the Department of Justice and the Federal Trade Commission.

Market Concentration is often one useful indicator of likely competitive effects of a merger. In evaluating market concentration, the Agencies consider both the post-merger level of market concentration and the change in concentration resulting from a merger.

Market shares may not always fully mirror the competitive consequence of firms in the market or the impact of a merger. They are used in conjunction with other evidence of competitive effects.

When analyzing mergers between an incumbent and a recent or potential entrant, to the extent the Agencies use the change in concentration to evaluate competitive effects, they will obviously do so using projected market shares. A merger between an incumbent and a potential entrant can raise

significant competitive concerns. The lessening of competition resulting from such a merger is more likely to be substantial, the larger is the market share of the incumbent, the greater is the competitive implication of the potential entrant, and the larger is the competitive threat posed by this potential entrant relative to others.

The Agencies give more weight to market concentration when market shares have been stable over time, especially in the face of historical changes in relative prices or costs. If a firm has retained its market share even after its price has increased relative to those of its rivals, that firm already faces limited competitive constraints, making it less likely that its remaining rivals will replace the competition lost if one of that firm's important rivals is eliminated due to a merger.

By contrast, even a highly concentrated market can be very competitive if market shares fluctuate substantially over short periods of time in response to changes in competitive offerings. However, if competition by one of the merging firms has significantly contributed to these fluctuations, perhaps because it has acted as a maverick, the Agencies will consider whether the merger will enhance market power by combining that firm with one of its significant rivals.

The Agencies may measure market concentration using the number of significant competitors in the market. This measure is most useful when there is a gap in market share between significant competitors and smaller rivals or when it is difficult to measure revenues in the relevant market. The Agencies also may consider the combined market share of the merging firms as an indicator of the extent to which others in the market may not be able readily to replace competition between the merging firms that is lost through the merger.

Based on their experience, and as touched on above, the Agencies generally classify markets into three types:

- Unconcentrated Markets: HHI below 1500
- Moderately Concentrated Markets: HHI between 1500 and 2500
- Highly Concentrated Markets: HHI above 2500

The Agencies employ the following general standards for the relevant markets they have defined:

- **Small Change in Concentration:** Mergers involving an increase in the HHI of less than 100 points are unlikely to have adverse competitive effects and require no further analysis.
- **Unconcentrated Markets:** Mergers resulting in unconcentrated markets are unlikely to have adverse competitive effects and require no further analysis.
- **Moderately Concentrated Markets:** Mergers resulting in moderately concentrated markets that involve an increase in the HHI of more than 100 points potentially raise significant competitive concerns and often warrant scrutiny.
- **Highly Concentrated Markets:** Mergers resulting in highly concentrated markets that involve an increase in the HHI of between 100 points and 200 points potentially raise significant competitive concerns and often warrant scrutiny. Mergers resulting in highly concentrated markets that involve an increase in the HHI of more than 200 points will be presumed to be likely to enhance market power. The presumption may be rebutted by persuasive evidence showing that the merger is unlikely to enhance market power.

Conclusion

The purpose of these index thresholds is not to provide a rigid screen to separate competitively benign mergers from anticompetitive ones, although high levels of concentration do raise concerns. They actually provide one of several methods to identify some mergers unlikely to raise competitive concerns and some others for which it is particularly important to examine whether other competitive factors confirm, reinforce, or counteract the potentially harmful effects of increased concentration. The higher the post-merger HHI and the increase in the HHI, the greater are the Agencies' possible competitive concerns and the greater is the possibility that the Agencies will request additional information to conduct their analysis. **CW**