Financial Synergy in M&A

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Abstract This paper develops a continuous model to examine financial synergy when M&A timing is determined endogenously. In the first-best setting, the optimal capital structure after M&A is determined to maximize the total firm value. However, because the decision on M&A is made by equityholders, first-best results cannot be realized without restrictions on equityholders' behavior, such as debt covenants. Instead, equityholders maximize the sum of equity value and newly issued debt value to determine the optimal capital structure; that is, the existing debt value is ignored. Such a situation is called the second-best setting. We find that, when operational synergy is zero, purely financial synergy can motivate M&A in both the first-best and second-best settings. However, the optimal M&A timing is delayed and the financial synergy is smaller in the second-best setting, which reflects the existence of inefficiency. On the other hand, when operational synergy is negative, even if financial synergy is positive, its magnitude is insufficient to motivate M&A.

Keywords: Financial synergy; Optimal capital structure; Optimal M&A timing

JEL classification: G32; G34