Mergers & CR: Lecture Notes

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Module-II

Mergers & Acquisitions -Definition

- The phrase **mergers and acquisitions** (abbreviated **M&A**) refers to the aspect of Corporate Strategy, Corporate Finance and Management dealing with the buying, selling and combining of different Companies that can aid, finance, or help a growing company in a given industry to grow rapidly without having to create another business entity.
- In Business or in Economics a **Merger** is a combination of two Companies into one larger company.
- Such actions are commonly voluntary and involve Stock Swap or cash payment to the target. Stock swap is often used as it allows the shareholders of the two companies to share the risk involved in the deal.

Mergers & Acquisitions -Definition

- A merger can resemble a Takeover but result in a new company name (often combining the names of the original companies) and in new Branding; in some cases, terming the combination a “Merger" rather than an acquisition is done purely for political or marketing reasons.
- In the pure sense of the term, a **Merger** happens when two firms, often of about the same size, agree to go forward as a single new company rather than remain separately owned and operated. This kind of action is more precisely referred to as a **“Merger of equals."** Both companies' stocks are surrendered, and new company stock is issued in its place. For example, both Daimler-Benz and Chrysler ceased to exist when the two firms merged, and a new company, DaimlerChrysler, was created.

Acquisitions

- When one company takes over another and clearly established itself as the new owner, the purchase is called an **Acquisition**. From a legal point of view, the Target company ceases to exist, the buyer "swallows" the business and the buyer's stock continues to be traded.
- In practice, however, actual mergers of equals don't happen very often. Usually, one company will buy another and, as part of the deal's terms, simply allow the acquired firm to proclaim that the action is a merger of equals, even if it's **technically an Acquisition.** Being bought out often carries negative connotations, therefore, by describing the deal as a merger, deal makers and top managers try to make the takeover more palatable.

- A purchase deal will also be called a merger when both CEOs agree that joining together is in the best interest of both of their companies. But when the deal is unfriendly and is hostile, i.e. the Target Company does not want to be purchased, then it regarded as

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Whether a purchase is considered a **Merger, or an Acquisition** really depends on whether the purchase is friendly or hostile and how it is announced. In other words, the real difference lies in how the purchase is communicated to and received by the target company's board of directors, employees and shareholders.

Varieties of Mergers

- **Horizontal merger**- Two companies that are in direct competition and share the same product lines and markets.
- **Vertical merger**- A customer and company or a supplier and company. Think of a cone supplier merging with an ice cream maker. *Vertical mergers* occur when two firms, each working at different stages in the production of the same good, combine.
- **Market-extension merger -** Two companies that sell the same products in different markets.
- **Product-extension merger -** Two companies selling different but related products in the same market.
- **Congeneric Merger / Concentric Mergers** occur where two merging firms are in the same general industry, but they have no mutual buyer/customer or supplier relationship, such as a merger between a Bank and a Leasing company. Example: Prudential's acquisition of Bache & Company.

- **Accretive mergers** are those in which an acquiring company's earnings per share (EPS) increase. An alternative way of calculating this is if a company with a high price to earnings ratio (P/E) acquires one with a low P/E & **Dilutive mergers** are the opposite of above, whereby a company's EPS decreases. The company will be one with a low P/E acquiring one with a high P/E.

- **Conglomerate** : When two companies that have no common business areas. There are two types of mergers that are distinguished by how the merger is financed. Each has certain implications for the companies involved and for investors:

  A) Purchase Mergers - As the name suggests, this kind of merger occurs when one company purchases another. The purchase is made with cash or through the issue of some kind of debt instrument; the sale is taxable.

  Acquiring companies often prefer this type of merger because it can provide them with a tax benefit. Acquired assets can be written-up to the actual purchase price, and the difference between the book value and the purchase price of the assets can depreciate annually, reducing taxes payable by the acquiring company.

  B) Consolidation Mergers - With this merger, a brand-new company is formed and both companies are bought and combined under the new entity. The tax terms are the same as those of a purchase merger

- In some of the merger deals, a company can buy another company with cash, stock or a combination of the two.

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In smaller deals, one company acquires all the assets of another company.

Company X buys all of Company Y's assets for cash, which means that Company Y will have only cash (and debt, if they had debt before). Thus, Company Y becomes merely a shell and will eventually liquidate or enter another area of business.

- **Reverse merger** is another type of acquisition is a deal that enables a private company to get publicly-listed in a relatively short time period. **A reverse merger** occurs when a private company that has strong prospects and is eager to raise financing buys a publicly-listed shell company, usually one with no business and limited assets. The private company reverse merges into a "Shell" public company, and together they become an entirely new public corporation with tradable shares.
- **Takeover :** An Acquisition where the Target Firm did not solicit the bid of acquiring firm.

Why M & A?

- One plus one makes three is the main idea and is special alchemy of a Merger or an Acquisition. The key principle behind buying a company is to create shareholder value over and above that of the sum of the two companies. Two companies together are more valuable than two separate companies - at least, that's the reasoning behind M&A.
- Especially, when times are tough; strong companies will act to buy other companies to create a more competitive, cost-efficient company. The companies will come together hoping to gain a greater market share or to achieve greater efficiency. Target companies will often agree to be purchased when they know they cannot survive alone.
- **Synergy** is the magic force that allows for enhanced cost efficiencies of the new business. Synergy takes the form of revenue enhancement and cost savings. By merging, the companies hope to benefit from the following:
- **Staff reductions** - Mergers tend to mean job losses. Mostly from reducing the number of staff members from accounting, marketing and other departments. Job cuts will also include the former CEO, who typically leaves with a compensation package.
- **Economies of scale** - Yes, size matters. A bigger company placing the orders can save more on costs. Mergers also translate into improved purchasing power to buy equipment or office supplies - when placing larger orders, companies have a greater ability to negotiate prices with their suppliers.
- **Acquiring new technology** - To stay competitive, companies need to stay on top of technological developments and their business applications. By buying a smaller company with unique technologies, a large company can maintain or develop a competitive edge.
- **Improved market reach and industry visibility** - A merge may expand two companies' marketing and distribution, giving them new sales opportunities. Because of improved financial standing, Bigger firms have an easier time raising capital than smaller ones.

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- **Overcome the Entry barriers:** M & A is one of the way for smooth market entry, as good will of another company and the brand gets transferred to new entities without initial hiccups. These costly barriers to entry otherwise would make "Start-ups" economically unattractive. **e.g. "**Belgian Fortis' acquisition of American Banker's Insurance Group".

- Eliminating the **Cost of new product Development.** Buying established business reduces risk of start-up ventures. **e.g.** "Watson Pharmaceuticals' acquisition of Thera Tech".

- **Lower risk** compared to developing new products.

- Increased feasibility and speed of **Diversification.** This is a quick way to move into businesses when firm currently lacks experience and depth in industry. **e.g. "**CNET's acquisition of "mySimon".

- Acquisition is intended to avoid **excessive competition** and improve competitive balance of the industry and thereby **Increased Market Power** and allowing market entry in a timely fashion. Firms use acquisition to restrict its dependence on a single or a few products or markets. **e.g. "**British Petroleum's acquisition of U.S. Amoco.; Kraft Food's acquisition of Boca Burger; "General Electric's acquisition of NBC.

Problems of M & A

- **Integration Difficulties:** Differing financial and control systems can make integration of firms difficult. **e.g. "**Intel's acquisition of DEC's semiconductor division.

- **Inadequate Evaluation of Target:** Competitive bid causes acquirer to overpay for firm. **e.g.** "Marks and Spencer's acquisition of Brooks Brothers".

- **Large or Extraordinary Debt :** Costly debt can create onerous burden on cash outflows. **e.g.** "Agrbio Tech's acquisition of dozens of small seed firms".

- **Inability to Achieve Synergy:** Justifying acquisitions can increase estimate of expected benefits. **e.g**. "Quaker Oats and Snapple".

- **Overly Diversified:** Acquirer doesn't have expertise required to manage unrelated businesses. **e.g. "**GE prior to selling businesses and refocusing".

- **Managers Overly Focused on Acquisitions:** Managers may fail to objectively assess the value of outcomes achieved through the firm's acquisition strategy. **e.g. "**Ford and Jaguar".

- **Too Large:** Large business bureaucracy reduces innovation and flexibility.

10 Major Change Forces Contributing Merger activity

- The pace of Technology has accelerated.
- The costs of communication and Transportation have greatly reduced.
- Hence markets have become international in scope.
- The forms, sources and intensity of competition have expanded.
- New Industries have emerged.
- While regulations have increased in some areas, generally more deregulations have taken place in other industries.
- Favourable economic and financial environments have persisted from 1982 to 1990 and from 1992 to 2000.
- Within a general environment of strong economic growth, problems have developed in individual economics and industries.
- Inequalities in income and wealth have been widening.
- Valuation relationships and equity returns for most of 1990s have risen to levels significantly above long-term historical patterns.

Merger Motives at a Glance

SYNERGY

Short Term Financial Synergy	Long Term Financial Synergy	Operating Synergy
EPS & PE Efficiency	Increased Debt Capacity	Economies of Scale
Improved Liquidity	Improved Capital	No Growth in Industry
Tax Effects	Redeployment	Limited Competition
	Reduction in Debt	Acquiring Technical & Managerial Knowledge
	Bankruptcy Costs	Product Extension
	Stabilizing Earnings	Market Extension
		Reduction in Risk & Uncertainty

Merger Motives at a Glance

Target Undervaluation

- Market Inefficiency (Economic Disturbances)
- Inside Information
- Superior Analysis
- Displacing Inefficient Managers

Managerial Motives

- Power Needs
- Size
- Growth
- Executive Comparison
- Insider
- Human Capital
- Risk Diversification

Peter Drucker's Five Commandments for Successful Acquisition / Mergers

- Acquirer must contribute something to the acquired Company.
- A common core of unity is required.
- Acquirer must respect the business of the acquired company
- Within a year or so, acquiring company must be able to provide top management to the acquired company.
- Within the first year of Merger, managements in both companies should receive promotions across the entities.
- Be sure there is some element of relatedness, but don't be too restrictive in defending the scope of potential relatedness.
- Combining two companies is an activity involving substantial trauma and readjustment. Therefore, a strong emphasis on maintaining and enhancing managerial rewards and incentives is required in the post –merger period.
- The risk of mistakes stemming from wishful thinking are especially great in mergers. The planning may be sound from the standpoint of business or financial complementarities or relatedness. But if the price is not right, some one is going to hurt.

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Major Challenges to Merger Success

- Look into three important areas : Due Diligence, Cultural Factors & Implementation.

Due Diligence:

- Check all legal Aspects including pension funding, environmental problems, product liabilities etc.
- Check all business & management considerations involving examining accounting records, maintenance & quality equipments, possibility of cost controls, potentiality of product improvements.
- Management's relationship with its employees, gaps in managerial capabilities, how these management systems will fit together, need to hire or fire managers, etc.
- Ensure that acquired unit is worth more as apart of the acquiring firm than being left alone or with any other firm.

Cultural Factors:

- Check organisation's values, traditions, norms, beliefs and behaviour patterns.
- Check formal statements available but observe informal relationships and networks.
- Check management's operating style. The firm must be consistent in its formal statements of values and kinds of actions that are rewarded.
- Check need of proactive employee training for growth through Merger.
- Check cultural factors in addition to products, plant & equipment.
- Check how the organisation has handled cultural factors in the past.
- Cultures may move to similarity. Or differences may even be valued as sources of increased efficiency.

Implementation:

- Implementation starts as condition for thinking about M & A.
- The firm must have implemented all aspects of efficient operations before it can effectively combine organisations.
- The acquiring firm must have shareholder value orientation with strategies and organisational structures compatible to multiple business units.
- Mergers should further Corporate strategy, strengthening weaknesses, filling gaps, developing new growth opportunities and extending capabilities.
- Integration leadership with management leadership qualities, experience with external constituencies and credibility with the various integration participants.
- Provide early, frequent & clear integration messages. Lack of communications causes distress. Ensure quick integration.

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Why M & A fail ?

- Plenty of Mergers don't work : Historical trends show that roughly two thirds of big mergers will disappoint on their own terms, which means they will lose value on the stock market
- The motivations for merger can be flawed and estimated efficiencies from economies of scale prove elusive. Many a times problems associated with merged companies are beyond solution.
- **Flawed Intentions:** Mergers that have been encouraged by booming stock market spell trouble.
- Deals done with highly rated stock as currency are easy and cheap, but without any the strategic thinking behind them.
- Also, mergers are often attempt to imitate just because somebody else has done a big merger. A merger may often have more to do with glory-seeking than business strategy.
- Most CEO's get a big bonus for merger deals, no matter what happens to the share price later.
- Mergers sometimes are driven by generalized fear. Globalization, the arrival of new technological developments or a fast-changing economic landscape, with idea that only big players will survive a more competitive world.

The Obstacles to Making it Work

- Coping with a merger can make top managers spread their time too thinly and neglect their core business, spelling doom.
- Too often, potential difficulties seem trivial to managers caught up in the thrill of the big deal.
- The chances for success are further hampered if the corporate cultures of the companies are very different.
- When a company is acquired, the decision is typically based on product or market synergies, but cultural differences are often ignored. It's a mistake to assume that personnel issues are easily overcome. For example, employees at a target company might be accustomed to easy access to top management, flexible work schedules or even a relaxed dress code. These aspects of a working environment may not seem significant, but if new management removes them, the result can be resentment and shrinking productivity.
- More insight into the failure of mergers is found in the highly acclaimed study from McKinsey, a global consultancy. The study concludes that companies often focus too intently on cutting costs following mergers, while revenues, and ultimately, profits, suffer.

- Merging companies can focus on integration and cost-cutting so much that they neglect day-to-day business, thereby prompting nervous customers to flee. This loss of revenue momentum is one reason so many mergers fail to create value for shareholders.
- But remember, not all mergers fail. Size and global reach can be advantageous, and strong managers can often squeeze greater efficiency out of badly run rivals. Nevertheless, the promises made by deal makers demand the scrutiny of investors. The success of mergers depends on how realistic the deal makers are and how well they can integrate two companies while maintaining day-to-day operations.

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