Mergers and Acquisitions

Prof. Sudhanshu Pandiya,

IBM,CSJM University, Kanpur.

Definition

" THE ACQUISITION OF A GOING BUSINESS BY ANOTHER THROUGH PURCHASE, EXCHANGE OF CAPITAL STOCK OR OTHER DEVICE."

(DICTIONARY OF ACCOUNTANTS)

- **BY *ERIC KOHLER***

“A TAKEOVER MAY BE DEFINED AS A TRANSACTION OR SERIES OF TRANSACTIONS WHEREBY A PERSON (INDIVIDUAL, GROUP OF INDIVIDUALS OR COMPANY) ACQUIRES CONTROL OVER THE ASSETS OF A COMPANY , EITHER DIRECTLY OR BY BECOMING THE OWNER OF THOSE ASSETS OR INDIRECTLY BY OBTAINING CONTROL OF THE MANAGEMENT OF THE COMPANY WHERE SHARES ARE CLOSELY HELD (HELD BY A SMALL NUMBER OF PERSONS) , A TAKEOVER WILL GENERALLY BE EFFECTED BY AGREEMENT WITH THE HOLDERS OF THE WHOLE OF THE SHARE CAPITAL OF THE COMPANY BEING ACQUIRED,

WHERE THE SHARES ARE HELD BY THE PUBLIC GENERALLY, THE TAKEOVER MAY BE EFECTED:

I) BY ARRANGEMENT BETWEEN THE ACQUIRER AND THE CONTROLLERS’ OF THE ACQUIRED COMPANY ;

II) BY PURCHASE OF SHARES ON THE STOCK EXCHANGE OR

III) BY MEANS OF TAKEOVER BID.”

- **W.A. WEINBERG**

KEY POINTS FOR MERGERS AND ACQUISITIONS

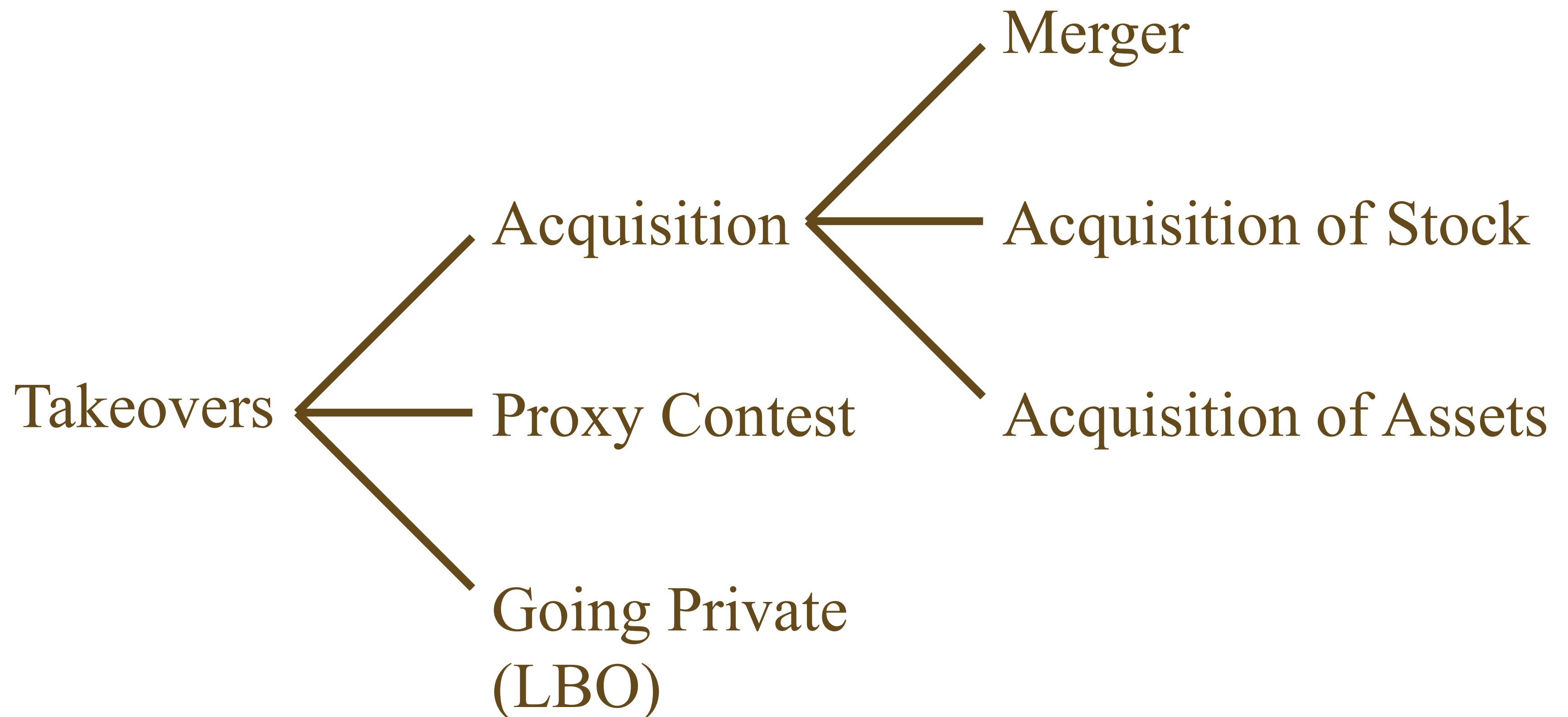
1. How does the merger help the parent company?
2. Does it add to the existing strengths ?
3. Does it provide an assured source of raw material ?
4. Does it provide forward integration ?
5. Does it provide optimal utilization of the existing resources ?
6. Why should they take over the particular unit and not some other unit?
7. What are its unique features ?
8. How do they mesh-in with the existing features of the parent company ?
9. Why is the parent company selling out ?
10. Is the unit inherently ok ?

11. Are there any basic problems, which are not open to easy solutions?
12. What are the post merger problems are likely to arise ?
13. Is the parent company fully prepared to tackle them?
14. How would the FIs react to the proposal?
15. What new conditions are likely to impose?
16. What would be the impact on the share prices of the parent company?
17. Impact on sales turnover and profitability of the parent company after the takeover and merger?
18. What is the right price for the unit ?
19. How should it be paid ?
20. What should be the exchange ratio ?

The Basic Forms of Acquisitions

- There are three basic legal procedures that one firm can use to acquire another firm:
  - Merger
  - Acquisition of Stock
  - Acquisition of Assets

Varieties of Takeovers



The Tax Forms of Acquisitions

- If it is a taxable acquisition, selling shareholders need to figure their cost basis and pay taxes on any capital gains.
- If it is not a taxable event, shareholders are deemed to have exchanged their old shares for new ones of equivalent value.

Accounting for Acquisitions

- The Purchase Method
  - The source of much "goodwill"
- Pooling of Interests
- Pooling of interest is generally used when the acquiring firm issues voting stock in exchange for at least 90 percent of the outstanding voting stock of the acquired firm.
- Purchase accounting is generally used under other financing arrangements.

Determining the Synergy from an Acquisition

- Most acquisitions fail to create value for the acquirer.
- The main reason why they do not lies in failures to integrate two companies after a merger.
  - Intellectual capital often walks out the door when acquisitions aren't handled carefully.
  - Traditionally, acquisitions deliver value when they allow for scale economies or market power, better products and services in the market, or learning from the new firms.

Source of Synergy from Acquisitions

- Revenue Enhancement
- Cost Reduction
  - Including replacing ineffective managers.
- Tax Gains
  - Net Operating Losses
  - Unused Debt Capacity
- The Cost of Capital
  - Economies of Scale in Underwriting.

Calculating the Value of the Firm after an Acquisition

- Avoiding Mistakes
  - Do not Ignore Market Values
  - Estimate only *Incremental* Cash Flows
  - Use the Correct Discount Rate
  - Don't Forget Transactions Costs

A Cost to Stockholders from Reduction in Risk

- The Base Case
  - If two all-equity firms merge, there is no transfer of synergies to bondholders, but if…
- One Firm has Debt
  - The value of the levered shareholder's call option falls.
- How Can Shareholders Reduce their Losses from the Coinsurance Effect?
  - Retire debt pre-merger.

Two "Bad" Reasons for Mergers

- Earnings Growth
  - Only an accounting illusion.
- Diversification
  - Shareholders who wish to diversify can accomplish this at much lower cost with one phone call to their broker than can management with a takeover.

The NPV of a Merger

- Typically, a firm would use NPV analysis when making acquisitions.
- The analysis is straightforward with a cash offer, but gets complicated when the consideration is stock.

The NPV of a Merger: Cash

NPV of merger *to acquirer* = Synergy – Premium

$$\text{Synergy} = V_{AB} - (V_A + V_B)$$

$$\text{Premium} = \text{Price paid for } B \text{ - } V_B$$

NPV of merger *to acquirer* = Synergy - Premium

$$= [V_{AB} - (V_A + V_B)] - [\text{Price paid for } B - V_B]$$

$$= V_{AB} - V_A - \cancel{V_B} - \text{Price paid for } B + \cancel{V_B}$$

$$= V_{AB} - V_A - \text{Price paid for } B$$

The NPV of a Merger: Common Stock

- The analysis gets muddied up because we need to consider the *post-merger* value of those shares we're giving away.

$$\text{Target firm payout} \geq \alpha \times \text{New firm value}$$

$$\alpha = \frac{\text{New shares issued}}{\text{Old shares} + \text{New shares issued}}$$

Cash versus Common Stock

- Overvaluation
  - If the target firm shares are too pricey to buy with cash, then go with stock.
- Taxes
  - Cash acquisitions usually trigger taxes.
  - Stock acquisitions are usually tax-free.
- Sharing Gains from the Merger
  - With a cash transaction, the target firm shareholders are not entitled to any downstream synergies.

Defensive Tactics

- Target-firm managers frequently resist takeover attempts.
- It can start with press releases and mailings to shareholders that present management's viewpoint and escalate to legal action.
- Management resistance may represent the pursuit of self interest at the expense of shareholders.
- Resistance may benefit shareholders in the end if it results in a higher offer premium from the bidding firm or another bidder.

Divestitures

- The basic idea is to reduce the potential diversification discount associated with commingled operations and to increase corporate focus,
- Divestiture can take three forms:
  - Sale of assets: usually for cash
  - Spinoff: parent company distributes shares of a subsidiary to shareholders. Shareholders wind up owning shares in two firms. Sometimes this is done with a public IPO.
  - Issuance if tracking stock: a class of common stock whose value is connected to the performance of a particular segment of the parent company.

Going Private and LBOs

- If the existing management buys the firm from the shareholders and takes it private.
- If it is financed with a lot of debt, it is a *leveraged buyout* (LBO).
- The extra debt provides a tax deduction for the new owners, while at the same time turning the pervious managers into owners.
- This reduces the agency costs of equity

Other Devices and the Jargon of Corporate Takeovers

- Golden parachutes are compensation to outgoing target firm management.
- Crown jewels are the major assets of the target. If the target firm management is desperate enough, they will sell off the crown jewels.
- Poison pills are measures of true desperation to make the firm unattractive to bidders. They reduce shareholder wealth.
  - One example of a poison pill is giving the shareholders in a target firm the right to buy shares in the merged firm at a bargain price, contingent on another firm acquiring control.

Some Evidence on Acquisitions: The Short Run

Takeover Technique	Successful		Unsuccessful	
	Targets	Bidders	Targets	Bidders
Tender offer	30%	4%	-3%	-1%
Merger	20%	0%	-3%	-5%
Proxy contest	8%	NA	8%	NA

Some Evidence on Acquisitions: The Long Run

- In the long run, the shareholders of acquiring firms experience below average returns.
- Cash-financed mergers are different than stock-financed mergers.
- Acquirers can be friendly or hostile. The shares of hostile cash acquirers outperformed those of friendly cash acquirers. One explanation is that unfriendly cash bidders are more likely to replace poor management.

The Japanese Keiretsu

- Keiretsu are reciprocal shareholding and trading agreements between firms.
- Usually a group of firms affiliated around a large bank, industrial firm, or trading firm.
- Nobody knows for sure if forming a keiretsu pays off or not.

Thank you