

Mergers and Acquisitions

Types of takeovers: Deal financing

Cash transaction involves receipt of cash for shares by shareholders in the target company.

Share transaction involves receipt of shares or combination of cash and shares in the merged company in exchange of shares held in the target company.

Going private transaction is a special form of acquisition where the purchaser already owns a majority stake in the target company.

Type of mergers:

Horizontal merger results in the consolidation of firms that are direct rivals i.e. sell substitutable products within overlapping geographical markets.

Vertical merger is the merger of firms that have actual or potential buyer-seller relationship.

Conglomerate merger involves consolidated firms that may sell related products, share marketing and distribution channels, or may be wholly unrelated.

Roll up transactions is combination of multiple small companies, in the same industry, to create one larger company.

IPO Roll up involves IPO from independent companies in the same industry tat merger into a single company concurrent with the stock offering.

Motivations of mergers:

1. **Synergies**- Synergy is the amount by which the value of the combined firm exceeds the sum value of the two individual firms.

$$\text{Value}_{\text{Synergy}} = \text{Value}_{\text{In place synergy}} + \text{Value}_{\text{Real option synergy}}$$

2. **Managerial motivations for mergers:** Manager may have their own motivations to pursue M7As and they may not always be in the best interest of the shareholders.

- a. **Increased firm size:** managers are often highly rewarded financially for building a bigger business.
- b. **Reduce firm risk through diversification:** managers have undiversified stake in the business and M&As can be used to diversify the business of the company and reduce risk.
- c. **Bootstrapping:** Bootstrap effect occurs when a high P/E firm acquires a low P/E firm and improves its reported EPS.
- d. **Co-insurance effect** is the benefit available to the bondholders because after merger the combined debt of the firms is safer because now earnings and assets of two firms are available to service the debt.

Sources of Synergies:

- 1. Revenue enhancement synergies
- 2. Cost reduction synergies
- 3. Asset reduction synergies
- 4. Tax reduction synergies
- 5. Financial synergies
- 6. Real option synergies
 - a. Growth Option Synergies
 - b. Exit Option Synergies

- c. Option to defer/ delay
- d. Option to alter operating scale
- e. Option to switch.

Shareholders Value at Risk (SVAR)

SVAR is the potential risk in and merger and acquisition transaction that synergies will not be realized or that the premium paid will be greater than the synergies that are realized.

Valuation issues in M&A (Detailed discussion of valuation is available in separate chapter)

Reasons for failure of mergers:

1. There is a risk of overpayment if merger deal is closed in bullish market conditions.
2. When merger is effected to satisfy the purpose of satisfying executive ego rather than under a prudent corporate strategy.
3. Where merger takes place as a defensive measure to neutralize the adverse effects of changes in corporate environment.
4. Conflict of corporate cultures of the companies involved.
 - a. Lack of communication
 - b. Lack of direct involvement by human resources
 - c. Lack of training
 - d. Loss of key people and talented employees
 - e. Loss of customers
 - f. Corporate cultural clash
 - g. Power politics
 - h. Inadequate planning

Hostile takeover is an acquisition in which company purchased doesn't want to be purchased or doesn't want to be purchased by a particular buyer.

Methods of hostile takeover:

1. **Tender offer** is a public bid for a large chunk of that target's stock at a fixed price. The offer has a time limit, and it may have other provisions that the target company must abide by if shareholders accept the offer.
 - a. **Two-tier tender offer** involves a bid, which offers a superior first tier price for a specified number of shares and a second-tier price to acquire the remaining shares.
2. **Proxy fight** involves a group of disgruntled shareholders or managers to band together and seek change of ownership of the company.

Defenses against hostile takeovers

1. **Shark repellants** are built-in defensive measures that make a company difficult to take over.
 - a. **Golden parachute** is provision under which CEO gets a large bonus in cash or stock if the company is acquired.
 - b. **Supermajority** provision requires a very high majority (70-80%) to approve of any acquisition.
 - c. **Staggered board of directors** prolongs the takeover process by preventing the entire board from being replaced at the same time.
 - d. **Dual class stock** is strategy under promoters of the company owns the voting stock while the stock sold to the public has little or no voting power.
2. **Poison Pills** are the steps undertaken by the company to make company an unattractive proposition once the takeover process has started.

- a. **Crown jewels** strategy involves getting rid of those specific parts of the company that are especially attractive to the potential acquirer.
- b. **People pill** is when high level managers and other key officers threaten to leave the company in case it is acquired.
- c. **Flip-in** provides provisions under which current shareholders can buy company's shares at deep discount in the event of a take over attempt.
- d. **Fat man** defense mechanism involves the target company borrowing a large amount of debt making itself far less attractive candidate for takeover.
- e. **Greenmail** is similar to blackmail where potential acquirer can buy large proportion of target and offer to resell the shares to the target at a premium.
- f. **Standstill agreements** are agreements with certain stockholders for not increasing their shareholdings beyond a certain percentage.
- g. **White Knight** defense is when the target company finds another company to come in and purchase it so that the company, which initiated the hostile takeover doesn't buy the target.
- h. **Pac man** defense is an offensive technique where target acquires shares of the potential acquirer and protects itself by being a threat to the acquirer.

Spin Offs:

Company owns or creates a subsidiary whose shares are distributed to the shareholders of the parent company on pro-rata basis.

Equity carve outs

Parent company sells a percentage of the equity of a subsidiary to the public in the stock market.

Split up

Company split into two or more parts, generally accomplished by initial carve outs, followed by spin offs of individual parts.

Reasons for divestitures:

Information: subsidiary's true hidden value is revealed once it's disintegrated from the parent.

Increased managerial efficiency with sharpened focus and elimination of negative synergy.

Managerial incentives enhanced by getting rid of bureaucracy and conflict of objectives between parent and subsidiary.

Bondholders expropriations, bondholders may benefit if junior debt of parent becomes senior debt of subsidiary.

Avoiding conflicts with customers in case parent is a competitor firm.

Enable focused merger strategy for future.

Defensive divestiture, for example for employing "crown jewel" strategy.

Reverse merger

Reverse merger is when a private company (shell company) merges with a publicly listed company that doesn't have any assets or liabilities.

Shell Company used in reverse merger is one of the following:

- A failed company that remains to be sold in order to recoup some of the costs of the failed business.

- Companies specifically formed for the purpose of being sold as sell in a reverse merger transaction.

Advantages of being publicly trading company:

- Increased liquidity of the ownership shares of the company.
- Greater access to capital markets through future stock offerings.

Advantages of reverse merger over IPO

- Less costs
- Lesser time required
- Less effected by market conditions.
- Less effected by lack of earning history of the company.



Leveraged Buy-outs

Acquisition of a company with a substantial portion of debt which is to be repaid by the cash flows of the target company.

Generally, LBOs are effected by financial buyers as opposed by strategic buyers.

Characteristics of an ideal LBO candidate:

1. Strong, predictable cash flows to service the financing costs.
2. Limited working capital and future capital requirements.
3. Readily separable assets or businesses that could be available for sale.
4. Real growth potential.
5. Viable exit strategy.

6. Products not subject to rapid technological change.

Management buy-outs are the LBO deals undertaken by managers.

