FINC3013: Mergers and Acquisitions

[Module 1]

Introduction, Acquisition Strategy and the Economics of M&A

- A 'merger' is a combination of two corporates in which only one survives. They are generally a negotiated, friendly deal between equals. In a merger, the acquiring company will assume the assets and liabilities of the merged company.
  - Technically speaking, a 'consolidation' differs from a 'merger' because neither companies in the transaction exist after the event. Instead a new company is formed. The term is used interchangeably with 'merger' in practice however.
  - Another term used is 'takeover'. It is sometimes used to refer to only hostile transactions. In other contexts it is used for both hostile and friendly transactions.
- A 'tender offer' is made directly to a firm's shareholders to buy their shares at a given price. This can be with or without the management's consent.
- An 'acquisition' can be any of the above. It is basically any deal.
- M&As are important instruments of macroeconomic renewal.

<u>Overview of the M&A Market</u>

- There are two ways to measure the level of activity in M&A: the volume of transactions and the aggregate value of transactions. The volume of transactions will be a measure of the breadth of M&A activity. The value of transactions will measure the depth of M&A activity.
- The value of M&A fluctuates with time, but has trended upwards with time.
- The number of M&A transactions has also increased with time and fluctuates.
- M&A activity has historical came in waves that see greater volumes and value of transactions.
  - There have been several waves of M&A with time:
    - The first wave (1897-1904) contained a number of horizontal mergers.
      - This wave coincided with economic and capital market buoyancy.
      - Firms sought to build market power in response to overcapacity that resulted from rapid technological innovation.
    - The second wave (1916-1929) contained a number of vertical mergers.
      - In this wave a number companies aimed to integrate their supply and distribution chains.
    - The third wave (1960s) contained a number of conglomerate mergers.
      - In the 1960s there was heighted antitrust enforcement that led to a limitation in horizontal mergers. As a such, diversification transactions dominated the activity.
    - The forth wave (1980s) contained a number of hostile takeovers, leveraged buy-outs ('LBOs') and MBOs.
      - This period featured an increase in the significance of financial and international buyers.
    - The fifth wave (1992-2000) contained a number of stock-based friendly mergers and cross-border mergers.
      - In the period following the recession at the beginning of the 1990s there were a number of strategic buyers eager to combine with targets who operated in related business lines.
      - This ended with the recession of 2000 and dotcom bubble of 2001.
    - The sixth wave (2003-2007) contained a number of private equity backed, LBOs.
  - The causes of these waves remains unsolved in finance, however a common theme is the presence of low interest rates and high equity prices. This makes financing transactions easier.
  - There seems to be an industry-based pattern of merger activity. Often a small number of industries will account for a disproportionate amount of M&A activity in a specific period.

- Offer premiums have trended downwards in the last 25 years from 50% to around 30%. However, there was an upwards trend from the late-90s to the early 2000's where premiums averaged just over 50%.

<u>Motives and Reasons of M&A</u>

- The economic basis for a merger is that the combined value of the two organisations together (after costs) is greater than the value of the two organisations if they were separate.
  - The gains from the merger will be expressed as:

$$Merger\ Gains = PV(A+B) \quad [PV(A) + PV(B)]$$

  - A merger should be undertaken if this gain is greater than the costs of the merger. The costs of a merger may involve:
    - Cash payments to target security holders.
    - The dilutive effect of issuing equities to provide to target shareholders or to finance the activity.
    - Investment banking fees.
    - Legal fees.
    - Interest payments on debt.
  - The net present value (NPV) of a merger event can be expressed as:

$$NPV\ = PV(A+B) \quad [PV(A) + PV(B)] + Premium \quad Expenses$$

- Some of the motives and reasons behind M&A are:
  - Growth:
    - M&A will be used for growth when a company is not able to grow fast enough by internal expansion.
      - Internal expansion usually takes more time than growth buy an acquisition and is referred to as 'organic growth'.
      - Growth through acquisitions is referred to as 'inorganic growth'.
    - The critical issue is the amount to pay for this increased speed of growth. Is the risk-adjusted return from the deal greater than what can be achieved with the next best use of capital.
    - Inorganic growth will be cheaper when stock market prices fall.
    - Johnson and Johnson is an example of a company that uses M&A as key part of their growth strategy. The made 50 acquisitions between 1995 and 2005. One of their bigger recent deals is the June 2012 acquisitions of Synthes Inc. for $19.7bn.
    - M&A as a growth strategy has its risks and can have unfavourable outcomes when poorly considered. For example, in 1994 Quakers Oats paid $1.7bn for Snapple which was later sold off for $300mn. This loss was the result of an overestimation of the growth potential.
    - Inorganic growth can be particularly effective when it involves expansion into a new geographical region where the specific knowledge of the area is of particular value to the acquirer.
  - Operating synergies (including economies of scale and scope):
    - Economies of scale are per unit costs savings that result from an increase in the volume of output. These may only exist within a certain range of output.
      - An example of this is the estimated $4.6bn of cost savings that resulted from the Exxon Mobile merger. This resulted from staff cuts, shared technology and other savings.
      - This will improve operating margins.
    - Economies of scope are where the average cost of producing different products together is lower than the cost when produced separately.
      - This cost savings may be the result of an overlap in R&D, marketing channels and other sharing of resources.

        - There may also be revenue-enhancement (this is generally difficult to achieve).
        - An example of a merger to provide economies of scope would be if banking industry mergers allowed a commercial bank to acquire a retail bank with a strong trust, benefiting both sides of the business.
        - This will also result in improvements to operating margins.
- Financial strategies:
    - Cash rich companies can be paired with those that have limited availability of funds but attractive investment opportunities.
    - Companies can use M&A to increase their debt capacity and improve their tax shields.
    - The increased size can reduce the cost of distress.
- Diversification:
    - A conglomerate merger occurs when companies are not competitors and do not have a buyer-seller relationship.
    - Diversification is a questionable motive for M&A.
    - The logic behind it is that the diversification will lower cash flow variability and thus, lower the cost of capital.
    - The argument against this is that shareholders can diversify their portfolio for a much cheaper cost. Shareholders do not have to engage in sizeable transactions (which brings about sizeable transaction costs – bankers, lawyers, accountants, etc.) and do not have to pay a premium.
        - Diversification mergers had a poor track record in the 1970s to 1990s.
    - Other arguments are made like that M&A activity can allow an optimal capital structure to be reached. However, this can be done more efficiently through other means.
    - Diversification can lead a company to enter into the wrong businesses. It can also be more difficult for the market to value company with a diverse range of business lines. This reduced monitoring ability can produce an agency cost.
    - Some academic studies have shown that that diversified firms perform worse than their narrowly focussed counterparts.
    - There are two different types of diversification though; that which is into fields related to a firm's business ('related diversification'), and that which is into unrelated business. Relatedness can be defined in two ways:
        - 'Vertically related' whereby the two businesses buy or sell inputs and outputs of each other.
        - 'Complementary' whereby the businesses jointly procure inputs or share distribution channels and marketing.
    - Complementary relatedness tends to have the greatest chance of producing higher values (per academic studies), as opposed to vertically related mergers and unrelated mergers.
- Agency problems:
    - The agency problem refers to the fact that there is a separation between ownership and control in corporations.
    - Agency problems will come about in a number of forms including:
        - Managers will prefer less effort and lower risk investments (given low incentive compensation).
        - Managers will substitute low risk for high risk investments (given high power, convex compensation and limited liabilities).
        - Mangers may be focused on short horizons is their decision making process.
        - Management may retain too much cash can keep leverage or dividends too low.
        - Managers may also inappropriately consume perks.