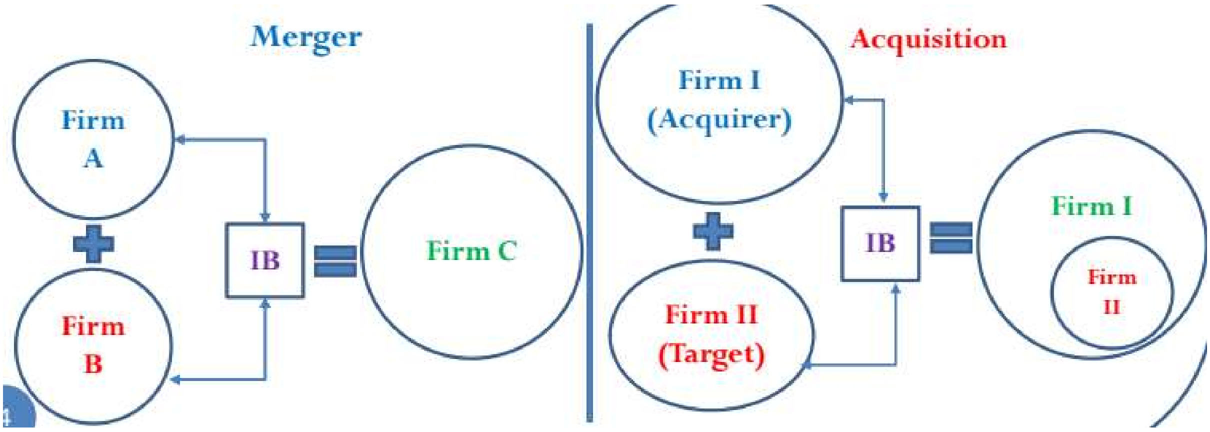
Topic 2 – Mergers and Acquisitions I: Participants and Strategies

Mergers and Acquisitions (M&A) = consolidation of companies or assets

Merger = combination of two companies to **form a new company**

Acquisition = **purchase of one company by another** in which no new company is formed



Types of M&A

- **Horizontal**
    - Firms in the *same line of business* (e.g. competition)
    - Examples: ExxonMobil, Damiler-Benz
- **Vertical**
    - Firms in the *same line of production* (e.g. supplier-retailer)
    - Examples: Coca-Cola buys bottling companies, Google acquired Motorola, Time Warner AOL (considered as the "worst deal ever")
- **Conglomerate**
    - Firms with *completely unrelated businesses*
    - Examples: General Electrics, Berkshire Hathaway acquires Duracell
    - Reason companies do this could be for diversification or new opportunities.

Motives and Strategic Rationale

- Synergies
    - **Cost synergies (more reliable) –** saving costs
        - Administration, manufacturing, procurement, marketing & distributions, etc.
    - **Revenue synergies (hard to measure)** – creating additional revenue
- Increase shareholder value (e.g. increase in EPS, ROE and/or ROIC).
- Increase market power (e.g. access to foreign markets)
    - Driver for revenue synergies
- Other considerations e.g. product differentiation, diversification, tax considerations, capitalise on untapped borrowing capacity, managers' incentives, etc.

Considerations

- **"Greenfield Analysis"** – deciding whether to make a product in-house or to buy it through an M&A. Comparing the costs, risks and benefits of an acquisition or merger with organic opportunity.
    - **"Stand-alone versus Merger Analysis"** – is it better to build a brand or is it better to acquire one?
- **Inverse decision** – deciding whether to sell the company/asset. Comparing the benefits of continuing to operate an asset or monetising the asset (for cash or stock of the acquirer).
    - Many start-ups begin with the intention of being sold to larger companies such as Google, Facebook, etc.

Principal Constituents

- **Shareholders**: concerned about valuation, control, risk and &tax issues.
- **Debt holders**: consider whether debt will be increased, retired or if there is potential for changing debt values.
    - Higher debt decreases value of existing debt as default risk increase.
- **Employees**: focus on compensation, termination risk & employee benefits.
- **Regulators**: anti-trust, tax and securities laws compliance (ACCC).
- **Union leaders**: worry about job retention and seniority issues.
- **Credit rating agencies**: focus on credit quality issues.
- **Equity research analysts**: focus principally on growth, margins, market share and EPS.

Measure of Market Concentration

- The Herfindalhl-Hirschman Index (HHI) is a measure of concentration within an industry.
    - HHI is constructed as the sum of the squared market shares of the firms in the industry:

$$HHI = \sum_{i=1}^{n}\left(\frac{Output\ of\ firm\ i}{Total\ Output\ of\ the\ market} \times 100\right)^2$$

- Regulators wouldn't be very worried if:
    - Post-merger HHI = <2000, or
    - Post-merger HHI = >2000 but the change in HHI is <100.
- A complete monopoly would have an HHI of 10,000.
- Companies can't manipulate the numbers in the HHI but they can manipulate public perception of an industry to get away with a merger.

Control and Purchase Price Premium

- In an acquisition, **control premium** is the difference (in %) between the price an acquirer will pay to purchase control of a target company compared to the price for owning a minority share (non-control) position.

    - Paying a premium for the right to decide how the company is run.
- The **purchase price premium** (to the target's current share price) in an acquisition is determined based on consideration of **synergies** and **control premium**.

Break-up Fee

- A **break-up fee** is paid if a transaction is not completed because a **target company walks away** from the transaction after a merger agreement or stock purchase agreement is signed.
- This fee is designed to discourage other companies from making bids for the target company since they would, in effect, end up paying the breakup fee if successful in their bid.
- **Reverse break-up fee** is paid if the **acquiring company walks away** from transaction after signing agreement.
- These fees are usually set at **2-4% of target company's equity value**, but this is subject to negotiation.

Acquisition currency

Methods of paying for M&A

- **Cash**
    - Directly from Cash of Acquirer's Balance Sheet, BUT forfeits interests earned on cash and tax on cash (to the target's shareholders)
        - Companies with large reserves of cash, such as Google and Apple, would use their cash when acquiring new companies.
- **Debt**
    - Raising debt/loans – vulnerable to excessive leveraging.
        - High Debt/Equity ratio affects credit-rating.
    - Sometimes, a company might acquire or merge with a larger company through getting a loan that's larger than the worth of the acquiring company.
        - It then uses the post-merger company to pay off the relatively huge debt of the acquiring company.
- **Equity**
    - Can be common and/or preferred stocks.
    - If a company doesn't have cash and/or can't raise debt, they can offer shares instead.
    - Represents in terms of exchange ratio = offer price of target/acquirer's close share price before deal is announced.
    - Bidders may see their own price fall because bidders pay too much, on average.
    - Risk of acquirer losing control by giving or issuing too many shares.
    - Using equity may have an underlying message regarding the acquirer's value to be overvalued.

Accretion and Dilution in M&A Transactions

- An **accretion/dilution analysis** compares a company's financial results before a proposed transaction to the results after the transaction.
- The analysis usually focuses on **EPS**

    - If the transaction results in an **increase in EPS**, this is **accretive** (may have positive impact on the company's share price).
    - If there is a **decrease in EPS**, this is **dilutive** (negative impact on company's share price)
- Unusual for a company to proceed with a dilutive M&A transaction **unless analysis suggests that EPS will become accretive within a short period of time**.
    - E.g. Google bought YouTube which only began making a profit, 5 years after the acquisition.

Fairness Opinion

Fairness opinion = an objective/uninvolved perspective from another investment bank regarding an M&A to see whether the deal is fair.

- Doesn't necessarily assess whether it's a deal that's good for either party regarding the price, but rather ensures that it makes sense and there are reasons behind the synergies.
- Fairness opinion is NOT an evaluation of the business rationale for the transaction, a legal opinion or a recommendation to the board to approve the transaction.
- Includes a summary of the valuation analysis conducted by the IB to show the basis on which the opinion is offered.

Natures of the Merger

- **Friendly merger:** boards on both sides negotiate and accept an offer.
- **Hostile takeover:** deal is opposed by the target company's board of directors and management.
    - Acquiring company/buyer can:
        - Make **tender offer** – public offer to buy shares of the target firm at a fixed price a **substantial premium** to the current market price. Only works when can obtain over 51% of the shareholders (target).
        - Engage in **proxy fight**, which is to take control of the target company's board and establish a new, favourable board of directors via **proxy vote** (a ballot cast by one person on behalf of a shareholder; may be another shareholder)

Hostile defences (shark repellents)

- Poison pills
    - Allows shareholders the right to buy shares of the company at a **substantial discount** (usually 50%) to market value if hostile company acquires certain percentage of shares → would lead to substantial **dilution of ownership** from the potential acquirer, making the takeover deal to be prohibitively expensive.
    - Damages the company just to keep a buyer away.
- Poison puts
    - Grants target firm's bondholders the right to **sell their bonds back** (or put them) to the target company → would increase the debt of the target firm, discouraging the potential acquirer as they would obtain the target's debt after acquisition.
- Golden parachutes

  - Offers substantial compensation packages to the senior management of the target company to compensate them from losing jobs after acquisition → this would increase the cost of acquiring firm.
- Staggered board of directors
  - Appoint board members to have longer term, and allow only a portion of directors sitting in election in any given year → would discourage acquirer from taking control via a vote in any given year.
- White knight
  - Seek a friendly investor to either purchase a target company or to take a substantial stake in the firm (e.g. Warren Buffett).
- Greenmail
  - **Paying** a potential acquirer to **go away and take no further attempt to acquire** the target company
    - Legally dubious → using shareholders' money to secure target managers' own jobs.

Types of Buyers: Financial vs. Strategic

- **Financial buyers** are primarily interested in a company's **return of equity, investment, capital structure and cash flow of the target company.**
  - They usually don't bring synergies to an acquisition.
- **Strategic buyers** are generally competitors of a target company and will benefit from synergies when they acquire or merge with target → *strategic buyers are usually able to **pay a higher price** than the price offered by financial buyers*
  - **E.g.** Google buying a company to strategically integrate the companies.
- However, sometimes financial buyers win auctions due to anti-trust issues or because they use **aggressive assumptions** on future cash flow (highly leveraged), **favourable financing terms** and **exit strategies.**