FINC3013: Mergers and Acquisitions

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Module 1: Introduction, Acquisition Strategy and the Economics of M&A

Introduction

Terminology:

Merger:

- Combinations of two corporations in which only one survives
- Generally a negotiated, friendly deal between equals
- Both firms' management support the deal, and it is then presented to shareholders

Tender offer:

- Offer made directly to a firm's shareholders;
- to buy their shares for a given price;
- with or without target management's consent
- if the takeover is opposed by target management then it is called a **hostile takeover**
  - When acquirer obtains majority of control ---> they replace former management

Acquisition:

- All of the above - basically any deal.
- General terminology

Importance of M&A:

M&As are important instruments of macroeconomic renewal

- Process of macroeconomic renewal i.e. removing weak companies, allowing strong companies to expand/consolidate, upgrade technology, respond to shocks
- M&A's are related to a wide variety of topics in corporate finance:
  - Agency costs/corporate governance
  - Valuation
  - Capital Structure
  - Corporate restructuring

Overview of the M&A Market:

- Seen as volatile by value. Has gone through waves since the late 90s e.g. peaked pre-dotcom bubble and pre-GFC.
- By numbers of M&A deals, it has gradually increased; less volatile/'waves'.
- In Asia Pacific, China the largest player. Australia second – very large market in relation to size of population.
  - Surge in China deals since 2007

History of merger waves:

- First wave (1897-1904) – horizontal mergers
- Second wave (1916-1929) – vertical mergers
- Third wave (1960s) – conglomerate mergers
- Fourth wave (1980s) – hostile takeovers, LBOs and MBOs
- Fifth wave (1992-2000) – stock-based friendly mergers and cross-border mergers
  - This was before the burst of the dot com bubble

        - Most deals were friendly deals
- Sixth waves (2003-2007) private equity + leveraged buyouts
    - A lot of debt, a lot of hostile takeovers
- Seventh wave (2014-?) – cross-border takeovers + LBOs
    - Example: China --> US, US --> Europe, UK --> India
        - Fox acquisition of Sky

Motives and reasons of M&A:

- Motivation is important to understand as it helps frame deals/understand the deals --> increases accuracy of valuations
- Growth faster through M&A
- Operating synergies – economics of scale and scope
- Financial synergies e.g. lower cost of capital and tax benefits
- Diversification – reduce fundamental risk
- Agency problem – M&A will generate higher bonuses for the managers
- Hubris hypothesis
- Horizontal mergers and pursuit of monopoly power
- Vertical integration benefits
- Deregulations
- Stock market driven

Economic basis for mergers:

- For the acquirer, the M&A process is a form of capital budgeting
- Gains from mergers = PV(A+B) – [PV(A)+PV(B)]
- Do merger if: **gain greater than costs of merger**
- Costs:
    - Cash payments to target stockholders i.e. premium to purchase target, need to offer shareholders a higher price than what the share is currently valued at
    - Securities – may dilute equity
    - Investment banking fees
    - Legal fees
    - Other fees (i.e. printers)
    - Interest payments on debt
- NPV = PV(A+B)-[PV(A)+PV(B)] – Premium – Expenses
    - Remember don't like look at share value --> look at NPV

Growth:

- Company may not be able to grow fast enough by internal expansion
    - Internal expansion usually takes more time than acquisition
    - This is called **organic growth**
        - Two characteristics:
            - It is cheap but slow.
    - Inorganic growth = acquiring another firm
- Critical issue: <u>premium paid for this speed</u>
    - Does the price of quicker development exceed the price paid for internal development by too much to justify difference?
- Falling stock prices

    - In periods of falling stock prices the costs of acquiring assets through purchase of whole companies may justify the acquisition
- Growth drive M&A depends on firm's strategy and market timing
    - Sometimes makes sense, sometimes doesn't.
- Growth through acquisitions (non-organic growth)
    - For many companies, M&A is key part of growth strategy
    - Johnson & Johnson: 50 acquisitions between 1995-2005
    - In 2005-2006 it tried to do its largest deal - $24.2 billion acquisition of Guidant
    - One of its recent big deals is the acquisition of medical-device makers Synthes Inc. of Switzerland for 419.7 billion in June 2012
- Growth in R&D development
    - Pfizer used its 2000 acquisition of Warner Lambert to acquire the leading selling drug in the world – Lipitor – it brings in nearly $11bn a year, about a sixth of Pfizer's revenue
    - Drug helped Pfitzer to become a leading pharmaceutical company in the world
- Examples of failed growth:
    - Quaker Oats Acquisiton of Snapple
        - '94 paid $1.7bn for Snapple
        - '97 sold off for $300m to Triaic Companies
        - Overestimated growth opportunities from Snapple, was already a mature company.

Operating Synergies: Scale and scope economics

- PV(A+B)>PV(A) + PV(B)
- Economies of scale
    - Cost savings due to increased output volume; elimination of duplicate facilities
    - May only last within certain range of output
    - Example: publishing: the recent merger of Penguin and Random House
    - It is possible to have <u>diseconomies of scale</u> which is when a firm becomes too large and inefficiencies arrive --> as output increases past the point of minimum cost, average cost also increases.
- Economies of scope
    - Average cost of producing different products together is lower than the cost when produced separately
    - Cost savings due to overlap in R&D, marketing channels, other sharing of resources (reduction in various departments such as marketing, purchasing, sales, and finance)
    - Revenue-enhancement (difficult to achieve)
    - Example: banking industry mergers – commercial bank with major retail network acquiring a bank with strong trust department
        - November 20, 2006: BOA acquired U.S. Trust from Charles Schwab for $3.3bn
        - BOA has lagged behind competitors in upper end private banking and wealth management business
        - Example: JP Morgan Chase and Citibank have much bigger wealth management business
    - Example: achieved cost economy synergies

- Exxon Mobil – announced in August 2000 that it expected $4.6bn in cost savings from its megamerger
- Merger: December 1998 - $82 billion
    - Created world's largest oil company
    - At that time the company predicted that the merger savings would $3.8 billion
    - By 2000 savings proved to be 20% higher
    - 2005: Company recorded largest profit ($36b) in history of corporations
- Source of gains
    - Job cuts: 19000 jobs from original workforce of 127000
    - More duplication than expected
    - Combined technology led to greatest cost savings in oil extraction than first thought