Valuation of M & A-

- **P/E Ratio & EPS**

  – If the **target company** shares are bought at **higher P/E ratio** than predator company shares, the **Predator company's EPS will fall**

  – If the **target company** shares are bought at **Lower P/E** ratio than predator company shares, the Predator company's **EPS will rise**

- Example 01

- " A" PLC consider to takeover "B" Ltd.

Company	Earnings	No of shares	P/E ratio
A	5000,000	1000,000	3
B	3000,000	600,000	-

– "A "decide to exchange their shares with "B" based market value of shares of both companies & "B" Ltd will receive " A" PLC shares equal to market value of " B" Ltd shares

– Determine the EPS after merger (assume no synergy)

1. If estimation of P/E ratio B Ltd is 2
2. If estimation of P/E ratio B Ltd is 4

Valuation under M & A- DCF Approach

- Merger is a special type of capital budgeting decision

- Steps:
  - Identify growth & profitability assumptions
  - Estimate cash flows & terminal value
  - Estimate cost of capital
  - Decide if acquisition is attractive on the basis of present value
  - Decide if acquisition should be financed through cash or exchange of shares
  - Evaluate the impact of the merger on EPS and PE ratio

Financing a Merger

- Cash Offer
  - What is the maximum price should pay
  - Does not cause any dilution of earnings

- Share Exchange
  - Determine the exchange ratio
  - Need to consider the *post-merger* value of those shares we're giving away.

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

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

Regulation of takeovers

- **Takeover regulation in Sri Lanka**
- The Srilankan SEC (Securities Exchange commission) monitors takeover activities in companies listed in Colombo Stock exchange (CSE)
- Accordingly takeovers & mergers code of 1995 (amended 2003) applies
- Code deals with three type of offers
  - Voluntary offers
  - Partial offers
  - Mandatory offers

- **Competition Legislation**
- Takeover & Mergers may be investigated by competition authorities to ensure that one company cannot dominate the market.
- Consumer affairs authority act of 2003 is the key competition legislation in Srilanka ensure that the sprit of the act is enforced