Session 11 &12

Mergers, Acquisitions and Divestures

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3 Ways of Acquiring a Firm

- Merger or consolidation
- Acquisition of stock
- Acquisition of assets

A **merger** refers to the absorption of one firm by another. The acquiring firm retains its name and identity, and it acquires all of the assets and liabilities of the acquired firm. After a merger, the acquired firm ceases to exist as a separate business entity.

A **consolidation** is the same as a merger except that an entirely new firm is created. In a consolidation, both the acquiring firm and the acquired firm terminate their previous legal existence and become part of the new firm.

3 Ways of Acquiring a Firm

- **Merger or consolidation**

Suppose firm A acquires firm B in a merger. Further, suppose firm B's shareholders are given one share of firm A's stock in exchange for two shares of firm B's stock. From a legal standpoint, firm A's shareholders are not directly affected by the merger. However, firm B's shares cease to exist. In a consolidation, the shareholders of firm A and firm B exchange their shares for shares of a new firm (e.g. firm C)

3 Ways of Acquiring a Firm

- **Acquisition of stock**

Purchase the firm's voting stock in exchange for cash

Private offer : From the management of one firm to another of firm

Tender offer : A public offer to buy shares of a target firm. It is made by one firm directly to the shareholders of another firm

1. In an acquisition of stock, shareholder meetings need not be held and a vote is not required
2. In an acquisition of stock, the bidding firm can deal directly with the shareholders of a target firm via a tender offer
3. Target managers often resist acquisition
4. Frequently a minority of shareholders will hold out in a tender offer, and thus, the target firm cannot be completely absorbed
5. Complete absorption of one firm by another requires a merger

3 Ways of Acquiring a Firm

- **Acquisition of assets**

- One firm can acquire another by buying all of its assets. The selling firm does not necessarily vanish because its "shell" can be retained
- A formal vote of the target stockholders is required in an acquisition of assets.
- An advantage here is that although the acquirer is often left with minority shareholders in an acquisition of stock, this does not happen in an acquisition of assets.
- Asset acquisition involves transferring title to individual assets, which can be costly.

Mergers and Acquisitions

- **Proxy contests :** Occur when a group attempts to gain controlling seats on the board of directors by voting in new directors. A proxy is the right to cast someone else's votes
- **Going-private transactions :** All of the equity shares of a public firm are purchased by a small group of investors. Usually, the group includes members of incumbent management and some outside investors
- **Leveraged buyouts (LBOs)** : large percentage of the money needed to buy up the stock is usually borrowed
- **Management buyouts (MBOs) :** When existing management is heavily involved in buying out the firm

Mergers and Acquisitions

- **Horizontal acquisition :** Here, both the acquirer and acquired are in the same industry.

  Exxon's acquisition of Mobil in 1998 is an example of a horizontal merger in the oil industry

- **Vertical acquisition :** A vertical acquisition involves firms at different steps of the production process.

  The acquisition by an airline company of a travel agency would be a vertical acquisition.

- **Conglomerate acquisition** : The acquiring firm and the acquired firm are not related to each other.

  The acquisition of a food products firm by a computer firm

Why Merge or Acquire

- **Synergy**

The two firms together are worth more than the value of the firms apart.

PVAB = PV A+ PV B + gains

- Market power

- Economies of scale

-Internalisation of transactions

- Entry to new markets and industries

- Tax advantages

- Risk diversification

Why Merge or Acquire

- **Superior Management**

Target can be purchased at a price below the present value of the Target's future cash flow when in the hands of new management

- Elimination of inefficient and misguided management

- Conglomerates advantages in allocating capital and in using extraordinary resources

- Under valued shares

Why Merge or Acquire

- **Managerial Motives**

Target can be purchased at a price below the present value of the Target's future cash flow when in the hands of new management

- Empire building

- Status

- Power

- Remuneration

- Hubris

- Survival : Speedy growth strategy to reduce probability of being takeover targets

- Free cash flow : Management prefer to use free cash flow in acquisitions rather than return it to shareholders

Why Merge or Acquire

- **Third Party Motives**

  - Advisers

  - At the insistence of customers or suppliers

Alternatives to Merger

Strategic Alliance : Agreement between firms to cooperate in pursuit of a joint goal.

Joint Venture : Typically an agreement between firms to create a separate, co-owned entity established to pursue a joint goal

Financial Side Effects of Merger

Earnings Growth

An acquisition can create the appearance of earnings growth, perhaps fooling investors into thinking that the firm is worth more than it really is

	Global Resources before Merger	Regional Enterprises before Merger
Earnings per share	$ 1.00	$ 1.00
Price per share	$ 25.00	$ 10.00
Price–earnings ratio	25	10
Number of shares	100	100
Total earnings	$ 100	$ 100
Total value	$2,500	$1,000

Financial Side Effects of Merger

Earnings Growth

- Global acquires Regional, with the merger creating no value
- Value of the combined firm will be \$
- At these values, Global will acquire Regional by exchanging of its shares for 100 shares of Regional.
- Global will have shares outstanding after the merger
- Combined firm EPS would be \$
- P/E ratio of the combined firm

Financial Side Effects of Merger

Diversification

- Diversification is often mentioned as a benefit of one firm acquiring another
- Diversification reduces unsystematic risk. We also saw that the value of an asset depends on its systematic risk, and systematic risk is not directly affected by diversification
- Stockholders can get all the diversification they want by buying stock in different companies. As a result, they won't pay a premium for a merged company just for the benefit of diversification.

Avoiding Mistakes

- **Do not ignore market values :** The current market value represents a consensus opinion of investors concerning the firm's value (under existing management). Use this value as a starting point. If the firm is not publicly held, then the place to start is with similar firms that are publicly held.
- **Estimate only incremental cash flows :** Only incremental cash flows from an acquisition will add value to the acquiring firm.
- **Use the correct discount rate :** The discount rate should be the required rate of return for the incremental cash flows associated with the acquisition. If Firm A is acquiring Firm B, more appropriate discount rate would be firm B's cost of capital because it reflects the risk of Firm B's cash flows.

Avoiding Mistakes

- **Be aware of transactions costs :** An acquisition may involve substantial (and sometimes astounding) transactions costs. These will include fees to investment bankers, legal fees, and disclosure requirements.

The Cost of Acquisitions

$$\Delta V = V_{AB} - (V_A + V_B)$$

Also, the total value of Firm B to Firm A, V_B^*, is:

$$V_B^* = V_B + \Delta V$$

The NPV of the merger is therefore:

$$\text{NPV} = V_B^* - \text{Cost to Firm A of the acquisition}$$

	Firm A	Firm B
Price per share	\$ 20	\$ 10
Number of shares	25	10
Total market value	**\$500**	**\$100**

The Cost of Acquisitions

	Firm A	Firm B
Price per share	$ 20	$ 10
Number of shares	25	10
Total market value	**$500**	**$100**

Both of these firms are 100 percent equity. You estimate that the incremental value of the acquisition is $100

The board of Firm B has indicated that it will agree to a sale if the price is $150, payable in cash or stock

Should Firm A acquire Firm B?

Should it pay in cash or stock?

Cash Vs Stock

- **Sharing gains** : If cash is used to finance an acquisition, the selling firm’s shareholders will not participate in the potential gains from the merger. Of course, if the acquisition is not a success, the losses will not be shared, and shareholders of the acquiring firm will be worse off than if stock had been used.

- **Taxes** : Acquisition by paying cash usually results in a taxable transaction. Acquisition by exchanging stock is generally tax-free

- **Control** : Acquisition by paying cash does not affect the control of the acquiring firm. Acquisition with voting shares may have implications for control of the merged firm

Defensive Tactics

- **The Corporate Charter**

The corporate charter consists of the articles of incorporation and corporate by laws that establish the governance rules of the firm.

Example : Usually two-thirds (67 percent) of the shareholders of record must approve a merger. Firms can make it more difficult to be acquired by changing this required percentage to 80% or so.

Another device is to stagger the election of the board members. This makes it more difficult to elect a new board of directors quickly. Such a board is sometimes called a classified board

Defensive Tactics

- **Repurchase and standstill agreements**

Managers may arrange a targeted repurchase to forestall a takeover attempt. In a targeted repurchase, a firm buys back its own stock from a potential bidder, usually at a substantial premium, with the proviso that the seller promises not to acquire the company for a specified period. Critics of such payments label them greenmail.

A standstill agreement occurs when the acquirer, for a fee, agrees to limit its holdings in the target. As part of the agreement, the acquirer often promises to offer the target a right of first refusal in the event that the acquirer sells its shares. This promise prevents the block of shares from falling into the hands of another would-be acquirer.

Defensive Tactics

- **Poison pills**

A poison pill is a tactic utilized by companies to prevent or discourage hostile takeovers

There are two types of poison pills:

- **A “flip-in”** permits shareholders, except for the acquirer, to purchase additional shares at a discount. This provides investors with instantaneous profits. Using this type of poison pill also dilutes shares held by the acquiring company, making the takeover attempt more expensive and more difficult

- **A “flip-over”** enables stockholders to purchase the acquirer’s shares after the merger at a discounted rate. For example, a shareholder may gain the right to buy the stock of its acquirer, in subsequent mergers, at a two-for-one rate.


ANY
QUESTIONS
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