

Module 6

Mergers and acquisitions

Introduction

We are examining mergers and acquisitions as they are becoming more common. We shall start our discussion by looking at the legal structure of mergers and acquisitions together with accounting matters. In this module we will concentrate on the important issues regarding mergers and acquisitions. After reading this you will come to know about sensible motives behind mergers and acquisitions.

Mergers and acquisitions (M&A) and corporate restructuring are a big part of the corporate finance world. Mergers prove very beneficial for the economy if these are successful. Some countries force poorer companies to merge with established organisations for the betterment of them as well as the economy. And it is no wonder we hear about so many of these transactions; they happen all the time. Next time you flip open the newspaper's business section, odds are that at least one headline will announce some kind of M&A transaction. Let us go through the definitions of merger and acquisition.

The combination of two or more companies, generally by offering the stockholders of one company securities in the acquiring company in exchange for the surrender of their stock, is known as merger.

A corporate action in which a company buys most, if not all, of the target company's ownership stakes in order to assume control of the target firm is said to be an acquisition. Acquisitions are often made as part of a company's growth strategy whereby it is more beneficial to take over an existing firm's operations and niche compared to expanding on its own. Acquisitions are often paid in cash, the acquiring company's stock or a combination of both.

In this module we will also discuss the benefits that the firms get after mergers and acquisitions. Not all mergers and acquisitions are successful and failure to produce the desired results is also focused on in this module. We have also elaborated the reasons behind the failures of mergers and acquisitions.

Upon completion of this module you will be able to:



Outcomes

- *define* mergers and acquisitions.
- *describe* the driving force behind mergers.
- *describe* types of mergers and acquisitions.
- *narrate* motives behind mergers and acquisitions.
- *describe* the legal process involved in mergers and acquisitions.
- *identify* the benefits likely to be realised from acquisitions.
- *determine* an appropriate pricing structure for a takeover bid.
- *identify* the reasons of mergers failure.



Terminology

Merger:	Combining the resources of two or more companies.
Acquisition of stock:	A firm purchases the voting shares of another firm in exchange of cash, shares or some other securities.
Acquisition of assets:	A firm acquires another firm via buying most or all of assets of acquiring firm
Horizontal merger:	The combining of two companies that are in direct competition with one another.
Vertical merger:	The merger between a customer and a company or a supplier and a company.
Conglomeration:	The merger of two companies that have no common business ties.
Market-extension merger:	Companies dealing in the same products and different markets, join hands.
Product-extension merger:	The product extension merger occurs between two business organisations that deal in products that are related to each other and operate in the same market.
Congeneric merger:	Two merging firms are in the same general industry, but they have no mutual buyer/customer or supplier relationship.

Reverse merger: Usually large company takes over smaller company but whenever a smaller company takes over a larger one.

Legal forms of acquisition

There are three legal procedures that can be used to acquire a firm

1. Merger or consolidation
2. Acquisition of stock
3. Acquisition of assets

1. Merger or consolidation

A merger is the combination of two firms. In the case of merger the two firms completely absorb each other. The acquiring firm retains its name and identity and owns all the assets and liabilities of acquired firm whereas the acquired firm does not have right to retain its name and identity. In consolidation, same as merger, there are two firms one is acquiring all the assets and liabilities of the other. The difference between merger and consolidation is that after consolidation a new firm is created. Both the acquiring and acquired firms cease to retain their identity. After consolidation a new firm arises at the business horizon.

2. Acquisition of stock

The second way a firm can use to acquire another firm is to purchase the voting shares of a firm in exchange for cash, shares or some other securities. This procedure of buying or acquiring the firm often starts as a private offer from one company to another. The direct offer of one company's shares to another company is known as tender offer. So it can be rightly said that acquisition of stock takes place through tender offer.

3. Acquisition of assets

A firm can be acquired by another firm if the acquiring firm buys most or all of assets of acquiring firm. In this case, the acquiring firm is not restricted to exist. This type of acquisition needs formal vote of all the existing shareholders. One benefit in this type of acquisition is that rights of minority shareholders are preserved.

What is merger?

Merger: Combination of all resources of two or more firms.

The word merger has been derived from the word merge which literally means to make a combination with another thing. Merger means the complete



absorption of one firm by another. In the business world, often companies combine with some other companies to get various economic, social or marketing benefits.

Companies want to become richer in case of assets and equity. Merger is the best channel to get richer. Mergers also involve risks and some issues but instead companies merge after proper analysis and research. Mergers are going to be very common in today's world due to incentives that acquiring company gets after successful accomplishment of mergers.

Types of mergers

- Horizontal merger
- Vertical merger
- Conglomeration
- Market-extension merger
- Product-extension merger
- Congeneric merger
- Reverse merger

Horizontal merger

The combining of two companies that are in direct competition with one another is called horizontal merger. In other words, they are trying to sell the same product to customers who are in a common market. The merger between competitors is said to be horizontal merger. This type of merger can either have a very large effect or little to no effect on the market. When two extremely small companies combine, or horizontally merge, the results of the merger are less noticeable. These smaller horizontal mergers are very common.

Vertical merger

The merger between a customer and a company or a supplier and a company is vertical merger. Suppose a garments company merging with a cotton production company. This would be an example of the supplier merging with the producer and is the essence of vertical mergers. This type of merger can be viewed as anticompetitive because it can often rob supply business from its competition. Antitrust concerns are a focal point of investigation if competition is hurt.

Conglomeration

A conglomeration is the merger of two companies that have no common business ties. They do not deal in the same products or same markets. There are two main types of conglomerate mergers – the pure conglomerate merger and the mixed conglomerate merger. The pure conglomerate merger is one

where the merging companies are doing businesses that are totally unrelated to each other. The mixed conglomerate merger is that where the companies merging work for the expansion of products or services they are already providing.

Market-extension mergers

Companies dealing in the same products and different markets, when join hands, are said to be in market-extension mergers. The major purpose of this type of merger is to get control over the market and to ensure a bigger client base.

Product-extension merger

The product extension merger occurs between two business organisations that deal in products that are related to each other and operate in the same market. The major purpose behind this merger is to get large number of customers and to ensure high profits.

Congeneric merger

Congeneric mergers take place where two merging firms are in the same general industry, but they have no mutual buyer/customer or supplier relationship, such as a merger between a bank and a leasing company.

Reverse merger

Usually a large company takes over a smaller company but whenever a smaller company takes over a larger one it's known to be reverse merger.

Acquisition

Acquisition is a corporate action in which a company buys, if not all, most of the assets of another company. Sometimes, according to the needs, circumstances and funds availability a company prefers to buy assets of other company rather get combined with it. This scenario is said to be acquisition. Acquisition in preference comes after merger.

In this acquiring, a firm is partially absorbed by another company and somehow the rights of shareholders are also preserved.

Classification of acquisition

- Friendly acquisition
- Hostile acquisition.



Friendly acquisition

In friendly acquisition, the companies' executives negotiate and all the decisions are taken on a mutual basis.

Hostile acquisition

In a hostile acquisition there is no negotiation among the executives. The whole process is performed by bidder and the bidder continues to seek it even the target firm is unwilling.

Difference between mergers and acquisitions

Both the terms “mergers” and “acquisitions” are used interchangeably but they have slight differences between them. Merger is a mutual decision and occurs when two organisations are agreed on being one while acquisition is buying of one organisation by another. Mergers can be categorised as horizontal, vertical, conglomerate etc. while acquisitions can be categorised as friendly acquisition or hostile acquisition. One of the differences between these two is of financial resources. Merger may not involve cash while acquisition needs cash put up.

Sensible motives for mergers

The motives for which mergers come into existence are:

- Economies of scale
- Optimum utilisation of resources
- Economies of vertical integration
- Use of surplus funds
- Diversification.

Economies of scale

Economies of scale imply an opportunity to spread fixed cost over a larger volume of output to enhance profit ratio. By combining two firms, the new one comes in the form of a mega setup which needs larger amount of material procurement for competing with same level firms. This procurement level reduces fixed costs by spreading it across the larger scale output.

Optimum utilisation of complementary resources

Sometimes small firms have ample talent but due to their size they lack the resources to compete in the market. Whereas in the same place larger firms may have resources but lack talent like engineering. In this case if these two firms merge, combining their resources which are complementary to each other, both will be highly benefited after being merged.

Economies of vertical integration

Vertical integration means to get control over the whole production process by combining backward with your suppliers and forward with your customers. To enjoy economies of vertical integration, companies merge with their suppliers and then move towards forward integration. This reduces transport cost as well as improving availability of material.

Use of surplus funds

Firms working in mature industries have surplus funds which can be utilised either by paying a dividend to shareholders or by repurchasing shares. But a rational manager never considers these options. Firms can buy shares of other companies forming a merger. So a merger provides a proper channel for utilisation of surplus funds.

Diversification

The word diversification means to spread your investment to enhance return as well as to minimise risk. Merger is a good way to diversify your investment. You can make a portfolio by buying shares of different companies.

Gains from mergers and acquisitions

- Synergy
- Cost reduction
- Revenue enhancement
- Tax benefits
- Reduction in capital needs
- Check on inefficient management.

Synergy

The positive incremental net gain associated with the combination of two firms either through merger or acquisition is called synergy. The first and foremost benefit for which one firm acquires another through any mode is synergy. It adds value to the firm either by increasing assets, goodwill or equity. A firm will acquire another firm if the value of a merged firm is greater than the individual value of firms before merger. In equation form it represents

$$\text{Value (A+B)} > \text{Value (A)} + \text{Value (B)}$$



Synergic effect can also be described as the difference between the values of the combined firm and the sum of the values of the firms as separate entities. When this difference between the values is positive, it is a sign of value addition to the acquiring firm. But when this difference indicates a negative sign firms will never decide to make a merger. By checking incremental cash flows you can determine the incremental value of an acquisition. These are the cash flows for the combined firm exceeding the separate cash flows generated by individual firms before merger.

Incremental cash flows can be broken down into four parts as:

$$\text{Incremental cash flow} = \text{increase in revenue} + \text{reduction in cost} + \text{reduction in tax} + \text{reduction in capital requirements}$$

On the basis of this breakdown, a merger will work only if these components show beneficial effects to the acquiring firm.

Cost reduction

Cost of the company is reduced by economies of scale and economies of vertical integration. Savings related to economies of scale (for example, fewer manufacturing plants each having improved capacity utilisation; more effective use of corporate resources such as IT). Economies of vertical integration (in 2001 there was a major move for media companies to acquire organisations that produce content that can be better used in a larger business). An example would be the Canwest Global Communications acquisition of the Canadian daily newspapers of Hollinger Inc. in 2001.

Tax savings

Under Canadian tax law, net operating losses can be carried back for up to three years and carried forward for up to seven. These losses are written off as expenses which reduce income level and alternatively tax imposed becomes less. Unfortunately, it is often the case that losses expire before they can be utilised due to the seven-year time limit. Therefore a company with net operating losses carried forward may be a worthwhile target. Eatons was a recent example of a company being acquired where its principal asset was tax losses. Sears Canada acquired Eatons to utilise the losses in a high-end department store operation that it set up in 2000. This was a fairly short run decision, with Sears' decision to convert the Eaton stores to Sears outlets in 2002.

Revenue enhancement

By mergers and acquisitions businesses raise their income level to a large extent. When a smaller company near to destruction is merged with a

stronger company having a large market share, it can enhance its revenues. The larger company will provide capital and all the other things needed to survive in the market by which earnings of the smaller company will be enhanced automatically. In another aspect savings or profit in business increases when its costs are cut.

$$\text{Profit} = \text{Revenue} - \text{Cost}$$

According to this equation profit can be enhanced either by increasing sales level or by decreasing cost. As discussed earlier, by merger you can reduce your cost as well as your tax expense; when these two decrease net profit of the business moves up.

Reduction in fixed and working capital

Benefits in these areas can include:

- Companies involved in manufacturing activities can reduce their future capital expenditures since less capacity will sometimes be required.
- Surplus assets can be sold to generate cash.
- Rationalisation of manufacturing and distribution facilities will usually mean less capital is required after merger.

Check on inefficient management

In the success of any organisation, management plays a very vital role. If management is effective as well as efficient, the company will grow speedily. Management acts as a backbone for any organisation. Sometimes companies merge with another sound management company to get the benefits of that well managed company's management. If your management is not doing work efficiently, you prefer to merge with a company in industry having sound management. New management will check points of inefficiency and enhance the effectiveness of previous management.

Accounting for mergers and acquisitions

As a result of mergers and acquisitions, a company's accounting statements will change. As per the tax rules, we are looking at this from a Canadian accounting perspective. Accounting treatment will vary in different jurisdictions. At the date of the acquisition, companies will have to determine the fair value of the net assets (total assets less liabilities) of the target company. The difference between this fair value estimate and the purchase price for the company is called goodwill. This is a new asset classified as an intangible capital asset. Each year companies must assess whether the value of this goodwill has been impaired at the date of preparing financial



statements. If goodwill has been impaired, then companies must recognise an impairment expense and reduce the value of goodwill by the amount of the impairment. If the value of the goodwill has not been impaired then no accounting entries take place and the value of goodwill is left as the amount of goodwill at the purchase date.

All assets and liabilities of the target company are restated to their fair market value at the date of purchase in the consolidated financial statements of the acquirer. This usually leads to increased charges for amortisation of capital assets amongst other things, which exerts downward pressure on reported earnings. Why? If the fair value of a capital asset is higher than its net book value of the target company's accounting records, you will have a higher capital asset value to amortise. The difference between the existing book value and the fair value of the capital asset at purchase must be amortised over the remaining useful life of the capital asset. Another example of this type of increased expense is inventory. If inventory fair values are greater than the book value of inventory at the date of purchase then the difference between fair value and book value must be included in cost of goods sold when the inventory is sold.

Structuring the purchase consideration

In this section we will examine what purchase consideration is best from the perspective of an acquiring company shareholder. Should we go cash or should we issue new shares? We will explore this issue by means of an example. To keep things simple, the example will consider cash versus shares only. In practice, many offers consist of a mixture of cash and shares. Alternatively, the offer may be in shares but with a cash option.

Example: X takes over Y, making it a wholly owned subsidiary

The table below contains pre merger information concerning X and Y.

Table: Merger Information for Company X and Company Y

Particulars	Company X	Company Y
Price per common share	\$20	\$10
Number of shares (millions)	25	10
Total market capitalisation (millions)	\$500	\$100

It will not surprise you to find that X will have to pay more than \$10 per share to acquire Y. Company X will have to pay a takeover premium to be successful with any bid. Let us suppose that a 50 per cent premium over current market value is required to obtain the support of Y's board of directors. In the previous section, we saw that X would expect to obtain some cash benefits from the acquisition arising from synergies between X and Y. Let's say that plants can be closed, head office personnel slashed, and prices increased due to higher market share. Furthermore, a financial evaluation

shows that the present value of the above benefits is \$100 million. Therefore, the value of Y to X is $100 + 100 = \$200$ million. We now examine the costs of acquiring the shares in the two cases.

Case A: Cash acquisition

The acquisition cost of Y = $150\% \times 100 = \$150$ million

The NPV of this option = Value of Y – Acquisition cost (cash)
= $200 - 150 = \$50$ million

Now, if the market has full access to all information considered by X's board and took the same view of the future then, the value of X after the merger would be:

Pre-acquisition value of X + value of Y – cost of acquisition = $500 + 200 - 150 = \$550$ million.

Therefore, the stock price would be $\$550 \text{ million} / 25 \text{ million shares} = \22 each, (i.e. gain in price of \$20.0 per share).

Case B: Share acquisition

To make a stock-based offer for Y, X will have to issue new shares worth \$150 million. Since the current price of X is \$20 per share, X will need to issue $150 \text{ million} / 20 = 7.5$ million new shares. Therefore, the number of X shares issued and outstanding after the acquisition is 25 million (per table) + 7.5 million = 32.5 million shares. Now the value of the new bigger X is: $500 + 200 = \$700$ million. Therefore, the market should value the shares in this case at $700 / 32.5 = \$21.54$ each. If you go back to case A, you will see that the share acquisition produces a lower price per share than the cash acquisition.

In fact, since the effect of the transaction is a stock price increase for X's shares you can argue that the lucky Y shareholders didn't receive \$15 each, they actually received more. We know that Y shareholders received 7.5 million shares in X. At the price after the deal was done, these 7.5 million shares were worth $7.5 \text{ million} \times 21.54$ (per previous paragraph) = \$161.55 million.

Now the net present value of this alternative is the value of Y including the synergies – the cost (i.e., $200 \text{ million} - 161.5 \text{ million} = 38.45 \text{ million}$), which is lower than the \$50 million shown as the NPV in the cash offer.

If we compare the two cases, A and B, why is A better? If you think about it, the result is not surprising. In A, when X pays cash, the existing X shareholders get to keep all of the synergy benefits, whereas in B they have to be shared with the shareholders of Y.



Considerations in choosing cash vs. stock

Real life, alas, is often quite different from the sort of contrived examples we put together. Here are some thoughts backed up by a cold dose of reality:

- Cash offers (which in reality will often involve borrowing at least some of the funds) will be the most attractive on paper since synergy gains belong entirely to the acquirer. Leverage adds to the attraction because the cost of debt financing is tax-deductible interest. As we saw in accounting, they typically produce higher earnings per share, which is attractive from an investor relations perspective.
- Cash offers maintain control. Many public companies are dominated by groups who wish to maintain control.
- The principal downsides of cash offers (which involve borrowing) arise from the increased risk flowing from additional debt plus the fact that these risks are borne by a smaller group of stockholders.

The negative aspects of borrowing to finance acquisitions are reinforced by the recent experiences of:

- Extencicare, an operator of long-term care homes. Large United States acquisitions produced some synergies, which were more than offset by losses incurred due to changes in the Medicare system.
- Laidlaw, the largest operator of buses in North America. Heavy losses arose from ambulance-based businesses acquired in the U.S.

Merger waves

Economic history has been divided into Merger Waves based on the merger activities in the business world as:

Period	Name	Facet
1889-1904	First Wave	Horizontal Mergers
1916-1929	Second Wave	Vertical Mergers
1965-1989	Third Wave	Diversified Conglomerate Mergers
1992-1998	Fourth Wave	Congeneric Mergers, Hostile Takeover, Corporate Raiding
2000-to date	Fifth Wave	Cross-border Mergers

Ways to acquire a company

- Acquisition with share/cash or a mixture
- Asset purchase: An alternative to acquiring shares

Acquisition with share/cash or a mixture

If an acquiring company wishes to acquire a target company, then it commonly makes what is known as a tender offer. This is an offer made by the acquiring company directly to the shareholders of the target. This can be an unfriendly offer (made without the support of the board of the target company) or can be a friendly offer that is supported by the target company's board. Either way the board of the target company has a responsibility to determine the fairness of the offer being made. A fairness opinion is sought from an investment-banking firm – and this may be expensive. In the case of unfriendly moves, the board of the target will usually try to find other bidders in order to get a higher price for the shares that are being sought. Bidders are frequently seeking 100 per cent of the common shares of the target or possibly some lesser number that provides a control position. Therefore a condition of any tender offer is that a minimum number of shares must be tendered, say 90 per cent. If the minimum is not tendered, then the acquiring company has no obligation to proceed with the bid.

Asset purchase: An alternative to acquiring shares

Most large acquisitions you read about are transactions based on acquiring the shares of a target company. The target itself may have a large number of subsidiaries, which become subject to the control of the acquiring company as a result of the transaction. Acquisition of shares is generally the easiest and cheapest way to accomplish the goals of the bidder.

An alternative, which is relatively common among private companies, is an asset purchase. Here the acquiring company purchases all the assets of the target company (land, buildings, equipment, inventories, and so on) and may take over liabilities and debt as part of the deal. The shareholders of the target company must vote in favour of such a move, which will essentially leave a corporate shell whose only asset will be cash. An asset purchase involves more work on the part of the acquiring company since legal title to the assets acquired will have to be obtained. The advantages to the acquirer are that it will not be encumbered with any of the obligations of the target, (for example, outstanding and potential lawsuits). This route can have major tax drawbacks for the shareholders of the target company. This can mean that a higher price may have to be paid to avoid acquiring the corporate structure associated with the target.

Other concepts related to mergers and acquisitions

- Defensive strategies
- Going private and leveraged buy out



- International mergers

Defensive strategies

No discussion on acquisitions is complete without some reference to contested takeovers. In this section we briefly mention some of the manoeuvres resorted to by a board wishing to fight off a predator. The one manoeuvre you have likely heard of is a share rights plan (SRP) or 'poison pill'. This is a financial device designed to make unfriendly takeover attempts unappealing if not impossible. These plans are set up such that should an acquirer make a bid, existing shareholders become entitled to rights that make it ruinously expensive for a bidder to proceed. The intention is to force all bidders to negotiate with the target's board of directors. Thus, a bidder knowing that an SRP is in place (it is matter of public record), must negotiate with the existing board and typically have the SRP set aside to allow a bid to proceed.

Going private and leveraged buyouts

Leveraged buyout: A method of acquisition in which most of the percentage of the purchase price is financed through leverage (borrowing). Shareholders in public companies can benefit financially when their company is taken over or acquired by another public company. As we saw previously in this block, bidders have to pay a takeover premium to be successful. However, public shareholders can also achieve a premium when their shares are bought out by an existing control group or when management buys out the company via a leveraged buyout (LBO).

For example, in 2001 Quebec Tel, a northern Quebec based telephone utility, was taken private by controlling shareholder AGT, a U.S. company, and BCT Telus. Following the acquisition of the public shares, a company is de-listed from the stock exchange and reverts to being a regular private company. Going private can produce attractive gains to public stockholders. If the private company thereby created is an LBO, its success will be enhanced by the magic of leverage. However, the undertaking has become much riskier due to the obligation to service a high debt load.

International mergers

Mergers vary in popularity in various countries and will be subject to different regulations, tax issues, and accounting treatment in the various countries. Aside from the level of mergers within the same country there is also activity in the merger area on the international realm. By this we are referring to a company in one country merging with a company from a different country. For example, you may have a U.S. corporation merging with a British company. These international mergers can provide both companies with benefits but they also increase the complications of the merger process. With international mergers companies must be aware of the regulations in place in the target company's country.

An acquiring company is not only faced with different regulations, they are potentially faced with different cultures. This can make shareholders of the target company reluctant to agree to the merger. It is important that companies research both the regulatory aspects and any cultural aspects. Many mergers fail when they are completed between two companies in the same country because joining two companies with different cultures can sometimes prove to be too much of a challenge. When you are entering the mix international borders, potentially different customs and business norms the chance of failure increases.

Why are international mergers attractive even with the increased risk? Acquiring an existing company in a foreign country is often less expensive than entering that market through the creation of a new company. If the company is already established and going well, then acquiring the company can use its good reputation to launch new products into a foreign market. They are more likely to be purchased from a well-respected local company than by a new foreign company. As with 'local' mergers, the target company may have technology that is of benefit to the acquiring company and merging may be viewed as the best means of gaining access to the technology. It may also be that a company has certain rights to an idea or a product that the acquiring company wants access to as well.

In addition to accessing products and new markets, the acquiring company is expanding its potential market for new capital. The acquiring company can potentially raise debt in the foreign country and issue shares in that country. These avenues for debt and capital may not have been available as a foreign company. Often the shareholders of the target company are interested in the merger for reasons beyond those of a national merger. Through the exchange of their shares for shares in an international company they cause a change to the risk level of their investment portfolio. This can be viewed as positive or negative depending on the shareholder's overall portfolio and risk tolerance. Although more factors need to be analysed in an international merger; they do occur and do occur successfully. The goal is to do your homework on both the company you are merging with and the country in which that company operates.

Why do mergers fail?

It is no secret that plenty of mergers fail. Mergers may not work as effectively as predicted. There may be many reasons behind failure of mergers. What may appear would be beneficial has not always been proven true. Reasons of failure are:

- Flawed intentions of executives
- Poor job of due diligence
- Globalisation
- Difference in corporate cultures.



The major reason behind failure may be flawed intention of executives. Executives may follow the suit when some others do it. But most CEOs get to where they are because they want to be the biggest and the best, and many top executives get a big bonus for merger deals, no matter what happens to the share price later.

Globalisation, the arrival of new technological advancements or a fast-changing financial landscape becomes a cause of failure of mergers. Difference between corporate cultures of the merging companies acts as an obstacle in the success of merger. A study by a global consultancy concludes that companies focus intently on cutting costs and as a result revenues and profits suffer. This loss of revenue momentum is one of the reasons of failure of mergers.

It is also a fact that not all the mergers fail. Strong mergers can often squeeze greater efficiency out of badly run rivals. The success of mergers depends upon how realistic the deal-makers are and how well they can integrate two companies while maintaining day-to-day operations.

Examples of mergers and acquisition in Pakistan

Year	Acquiring Company	Acquired Company	Nature
2002	Best Way Group	United Bank Limited	Acquisition
2005	Arif Habib Group	Pak Arab Fertilisers Limited	Acquisition
2006	Azgard Nine Limited	Pak-American Fertiliser Limited	Acquisition
2007	NIB Bank Limited	Pakistan Credit And Investment	Merger
2008	Yousuf Sugar Mills	Corporation	Merger

Examples of International Mergers and Acquisitions

Year	Purchaser	Purchased
1997	WORLD.COM	MCI Communication
1998	BELL Atlantic	GTE
1999	Vodafone AirTouch	Mannesmann
2001	COMCAST Corp.	AT&T Broadband & Internet Services
2004	JP Morgan Chase & Co	Bank One Corporation
2006	AT&T Incorporation	Bell South Corporation
2008	Inbev Incorporation	Anheuser-Busch Companies Inc.
2009	Pfizer Incorporation	Wyeth

Module summary



Summary

In this module you learned:

- Simply stated, a merger is the joining of two or more companies into a single enterprise. Acquisition refers to the acquisition of assets rather than merging the shares of two or more companies.
- Mergers can be divided into many categories like horizontal, vertical, market extension, product extension, conglomeration and congeneric mergers. Whereas acquisitions can be divided into friendly and hostile acquisitions.
- Mergers are subject to various levels of regulation both from business combination regulations in place, stock market requirements, tax rules, and accounting changes.
- Sensible motives behind mergers are economies of scale, economies of vertical integration, use of resources etc.
- A key item to note is that shareholders do have a vote in accepting the merger or not. For example, in Canada a minimum of two thirds of the voting shareholders have to approve the merger for it to go forward.
- Mergers and acquisitions can be facilitated through the exchange of shares, the purchase of outstanding shares for cash, or some combination of these two payment methods.
- The method of payment that is best will differ among merger deals and often among shareholders as not all shareholders have the same goals and the same circumstances.
- Tax rules around mergers are often complicated and merger-specific. Therefore, it is important to have a tax specialist on the merger team early in the process.
- The accounting required as a result of mergers is well defined in Canada in the Canadian Institute of Chartered Accountants Handbook. The most difficult component in this process is often the determination of the fair value of the target company's net assets.
- An increase to incremental cash flow per share is the primary benefit of mergers and acquisitions. These increases come from reduced costs, increased revenue, or both, or changes to working capital. (Note that an increase in working capital by itself would not justify a merger unless the new capital was cheaper than alternative sources on a net basis).

- Companies can be purchased through the exchange of cash, shares, or some combination of the two.
- All the mergers in the world do not succeed always. Success of mergers depends upon purity of intentions of deal makers and working not only for cutting cost but also for enhancing shareholders' wealth. If these issues are ignored, mergers would fail.
- Companies will sometimes take measures to make their company unattractive to potential merger partners/acquirers, either because they do not want to be taken over or because they want extra bargaining power via poison pills, etc.
- Public companies traded on the stock exchange, can be bought and then de-listed to become a private company.
- International mergers occur for many of the same reasons that national mergers occur.
- International mergers have added complications of working with regulations of more than one jurisdiction and cultural differences.



Assignment



Assignment

1. Discuss the main sources of value generated in most mergers and acquisitions. Are all of them in the interest of society as a whole?
2. Can an acquisition that is value increasing be a bad deal for the acquirer?
3. Why do firms like to acquire other firms?
4. What can an executive do to resist a takeover?
5. Is it true if hostile takeovers are rare, they should not matter very much?
6. Discuss the two main payment methods in acquisition offers?
7. Discuss the main sources of value generated in most mergers and acquisitions. Are all of them in the interest of society as a whole?
8. Can an acquisition that is value increasing be a bad deal for the acquirer?
9. Why do firms like to acquire other firms?
10. What can an executive do to resist a takeover?
11. Is it true if hostile takeovers are rare, they should not matter very much?
12. Discuss the two main payment methods in acquisition offers?

Assessment



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1. Levesque Distribution Inc., a Canadian company based in Montreal, operates a very large fleet throughout Quebec. The company has just made a tender offer for all of the common shares of Logitex Corp., a Toronto-based competitor. On the closing date for the tender, Levesque's investment banker reports that only 38 per cent of the Logitex shares have been tendered. Levesque has no alternative to taking up the shares that have been tendered.
 - a. True
 - b. False
2. Aviation Industries corp., a Canadian company, operates a regional airline based in Eastern Canada. The company is in the process of raising substantial funds for growth. It plans to acquire Westjet, and several other carriers. In putting together its merger proposal, Aviation Industries should consider:
 - a. Savings in leasing costs arising from a bigger fleet.
 - b. Savings in corporate head office expenses including IT.
 - c. Reductions in spare parts inventories.
 - d. A potential referral to the Competition Bureau.
 - e. All of the above.
3. Nebula B corp., a very widely held public company, is planning to take over a major competitor in its industry. The target's borrowings are about \$25 million. Expected rationalisation benefits arising from plant closures, and a reduction in corporate overhead are expected to be very significant. Nebula B currently has no debt and achieved a 27 per cent ROE in its latest financial year. The latest financial statements show shareholders' equity of \$650 million. The projected cost of the acquisitions is \$120 million. Which of the following options is likely to be the most attractive to Nebula B?
 - a. An offer consisting of 50 per cent common shares in Nebula B and 50 per cent in cash.
 - b. An offer consisting of 25 per cent common shares plus 75 per cent in the subordinated debentures of Nebula B.
 - c. A 100 per cent cash offer.
 - d. An offer consisting of 60 per cent common shares and 40 per cent in the convertible debentures of Nebula B.
4. Gamma Technologies is planning to acquire a competitor, Sirens of Titan Inc. (Sirens), based in Florida. Gamma and Sirens are



- manufacturers of medical diagnostic devices. Sirens is a private company that is highly profitable with minimal debt. However, reference to Sirens' statements indicates that the company has major outstanding lawsuits whose settlement is uncertain. Which of the following is likely to be the most attractive option to Gamma:
- a. Acquire Sirens and then hire the O.J. team to take care of the lawsuits.
 - b. Proceed with the acquisition but cut the purchase consideration to allow for the costs of settling the suits.
 - c. Make an all stock offer for Sirens, as that way its principals will have to help fight the suits.
 - d. Purchase the key assets of Sirens such as patents and know how.
5. Which of the following statements is not true concerning mergers of companies:
- a. Approval from the shareholders of both companies that are party to the merger is required.
 - b. The shareholders of the merger parties are never subject to taxes arising from the merger due to their ongoing interest in the merged entity.
 - c. Savings from mergers generally include a reduction in corporate head office expenses.
 - d. Regulatory approval is frequently required to satisfy the provisions of the Combines Investigation Act.
6. Incredible Foods Inc. (IFI) is a privately held food processing company. After six years of losses (totaling \$35 million), management advises stockholders that operations should cease as losses are expected to be even larger in the coming year. A closure at this point will provide just enough to pay off bank debt and other creditors. All bank debt is guaranteed by major stockholders. Which of the following options is the most attractive to IFI's shareholders?
- a. Close the doors right away.
 - b. Pay a \$10,000 fee to a merchant banking friend to find a purchaser of IFI.
 - c. Hang on for another year in case business improves.
 - d. None of the above.
7. Alpha and Beta Limited are the controlling shareholders (89 per cent) of Consolidated Gravel Inc., a publicly traded company. Both Alpha and Beta are publicly traded. The Consolidated shares are trading at a five year low of \$1.35 per share. Which of the following statements are not true with respect to Consolidated?

- a. Taking the company private would eliminate the need for an audit.
 - b. Taking the company private would eliminate the need for independents on the board of directors.
 - c. The company's net income would increase if it were taken private.
 - d. The shares could be acquired by the controlling shareholder for \$1.35 or less.
8. Lysistrata Corp. is planning to make a bid for 100 per cent of the common shares of Greek Island Adventures Inc. (GIA), a public company. A detailed financial analysis of the company indicates that is worth \$30 - 40 million. Which of the following factors will have the most impact on Lysistrata's ability to successfully acquire GIA:
- a. The existence of an SRP for GIA.
 - b. Service agreements with GIA's president that allow for a \$1 million severance package in the event of a takeover.
 - c. The fact that Lisa and Helen Panagopoulos between them own 53 per cent of GIA's shares.



Answer Key to Review Questions

1. b – The tender offer would contain a clause providing that a minimum percentage of shares must be tendered, usually 90%. This would allow Levesque to avoid being forced into purchasing a minority interest in Logitex.
2. e – All of the factors are relevant including (d). Since Air Canada has about 80% of the domestic market it is unlikely that the Competition Bureau would not sanction some element of rationalization by the competition.
3. c – All of (a), (b), and (d) involve shares. Each of these offers therefore involves sharing rationalization benefits with new shareholders. With (c), no sharing is involved as it is a cash offer. Such an offer is feasible since the company has no debt, is acquiring little debt from the target, and has substantial equity.
4. d – An asset purchase is the only way to escape potentially substantial claims from the lawsuits.
5. b – Taxes may be payable by both sets of shareholders – as they were in the case of TCPL/Nova. It all depends on the facts of the case.
6. b – The company has a potentially sizable asset in the shape of tax losses. Provided a purchaser can be found in the same business (not impossible in food processing) then these losses have a value. Therefore this option should maximize shareholder value. Option (c) is risky since bank debt is shareholder guaranteed.
7. d – Taking Consolidated private effectively constitutes a takeover. It is hard to imagine that no takeover premium would have to be paid to acquire the Consolidated shares.
8. c – Lisa and Helen control GIA and therefore the bid is going nowhere without their support. The SRP would have to be dealt with but it is of secondary importance compared to the attitude of the control block.

References



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