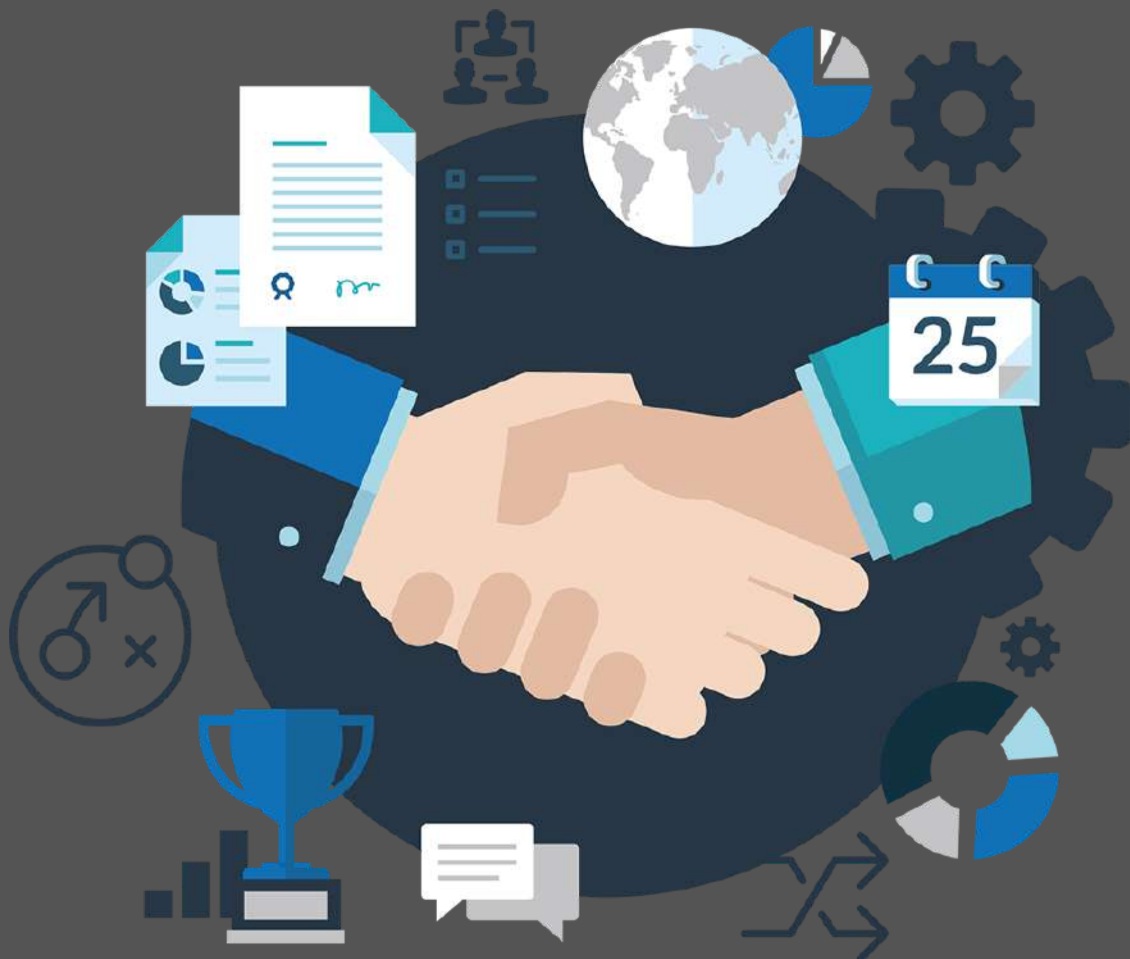
The Dynamics of MERGERS AND ACQUISITIONS

VOLUME 2



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STAGES OF MERGERS AND ACQUISITION

Business leader always look for opportunities to expand and thus look for new entities to tie up with them or take them over. For any successful M&A, business leaders must follow the following steps.

Identifying Growth Opportunities and scope for business expansion

The first step is to look for opportunities and the direction in which expansion can take place. For this, firms must acquire ***relevant data*** (like demographics, trends of preferences of customers, product or service line, demand projections and financials) and analyse them extensively. ***Internal analysis*** (like SWOT) as well as environmental scanning (like BCG matrix) needs to be done to identify market potential and market share.

Identifying target firm for merger or acquisition

This step involves looking for candidates for merger and acquisition. All suitable candidates should be taken into consideration. While some firms might be similar to our firm in terms of target group or product and service line, our analysis should not be restricted to just these firms.

Evaluating the feasibility and the strength of the target firm

After deciding the various candidates for M&A, the next step involves analysis of the ***possible synergies*** and risk involved. For this, financials should be strictly taken into account and carefully analysed. The relative cost and revenue should be compared and the firm to tie up with should be decided.

Conducting Valuation

The ***costs involved, demand projection, anticipated revenue and profit***, and many other factors determine the valuation of the deal. Corporate leaders must find alternatives for structuring M&A deal and evaluate them to select the best one. There are various methods of evaluating M&A deal. A few have been discussed under the section Valuation Methods for Mergers and Acquisitions deals.

Accretion or Dilution Analysis

Accretion or dilution analysis is a step to determine the effect of merger or acquisition on the ***Earning Per Share (EPS) of transferee company***. Accretion is when the EPS of the combined entity is higher than acquirer's EPS before the deal. Similarly, dilution is when the pro-forma (post deal) EPS is lower than acquirer's EPS. It determines whether the EPS will increase or decrease and whether it is affordable and feasible for the company to execute the deal.

Making a decision as to go for the deal

The most crucial step in the entire process is the decision whether to enter into a deal with the target firm or not. All the analysis done should be scrutinized before coming to a conclusion. ***SWOT and PESTLE analysis*** of the target firm and the combined entity should be deployed to decide the strengths and opportunities and overcome weaknesses and minimise threats. All ***possible synergies and drawbacks*** of the proposed new entity should be very carefully analysed to arrive at any decision.

Performing due diligence, negotiating agreement and executing the transaction

The ***information pertaining to the financial, legal and strategic position of the target firm*** should be verified to understand the issues, opportunities and risks involved in the transaction. Therefore, due ***diligence review*** must be conducted to ensure full disclosure of the information. Following this, an agreement shall be negotiated between the business leaders to ascertain the mutual terms, such that the deal is in the best interests of both the parties.

Implementing transaction and monitoring the performance

This step involves bringing an ***operational change in the functioning of the management, change in the workforce and tackling the issues of the employees*** in relation to the amalgamation and fulfilling the legal and environmental requirements. Once the amalgamation is executed, the rest is to ensure smooth functioning of the combined entities.

TYPES OF MERGERS AND ACQUISITION

Horizontal Merger/Acquisition

A Horizontal Merger refers to a situation in which ***a company takes over or merges another company offering similar product lines to the consumers.*** As the name suggests, both the companies are at the same stage of production. In simple terms, ***two organizations with comparative items/administrations come together.*** It leads to ***economies of scale*** due to increased production, thereby reducing costs and increasing profitability.

For example, In 2002 *Hewlett Packard took over Compaq Computers* for $24.2 billion. The objective was to make the dominant PC provider by combining the PC products of the two organizations.

Vertical Merger/Acquisition

In Vertical Mergers, ***two organizations in a similar industry unite, however, they are at various points on the supply chain.*** They become all the more vertically incorporated by ***improving coordination, solidifying staff and decreasing the time to advertise for items.*** It also helps to avoid disruption of supply.

An attire retailer who purchases a garment assembling organization would be a case of a vertical merger.

Conglomerate Merger/Acquisition

Two organizations in various businesses unite or one assumes control over the other to widen their scope of administrations and items. This methodology can help ***decrease costs by consolidating back-office exercises as well as reduce risk by working in the scope of ventures.***

There are **two types** of conglomerate mergers: *pure and mixed.* Pure conglomerate mergers involve firms with nothing in common, while mixed conglomerate mergers involve firms that are looking for product extensions or market extensions.

For example, *merger between L&T and Voltas Ltd.* Larsen & Turbo (L&T) is India's largest engineering company with expertise in wide area like infrastructure, oil and gas, power and process. And Volta a Tata group company, is a major player in the electro-mechanical Engineering.

Concentric Merger/Acquisition

This type of merger takes place between ***two organizations which share clients in a particular industry but don't offer the same services.*** This is generally undertaken to encourage customers, as it is comparatively easy to sell the products together. Selling one of the items will likewise support the clearance of the other, subsequently increasing the income of the organisation and hence the profitability. ***A model would be Sony who manufactures DVD players but who also bought the Columbia Pictures film studio in 1989.*** Sony was now able to produce movies to have the option to be played on their DVD players.

VALUATION METHODS

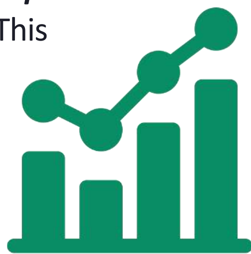
For the most part, when valuing a company, there are ***two unique ways to approach the valuation of the company: the first is the liquidation estimation of the company, and the second is the estimation of the company as a going concern.*** Frequently in a mergers and acquisitions transaction, the target company will be valued as a going concern, except if the target company is in trouble and the procuring company is obtaining it to strip it down and sell the assets, or to expel it from the market as a contender.

Other valuation considerations include:
(1) What stage the company is at in its life cycle;
(2) What it would cost for the acquirer to build a similar business;
(3) Observable growth history and healthy future prospects;
(4) Percentage of recurring revenue;
(5) Churn/retention rate;
(6) Gross margin;
(7) Customer acquisition costs;
(8) Addressable market size;
(9) Competition.

The following will include some of the ways to approach valuations in the mergers and acquisitions set, as well as some of their strengths and weaknesses.

Enterprise Value-to-Sales Ratio

This proportion is a valuation measure ***comparing a company's Enterprise Value to the sales of the company.*** This proportion is utilized by speculators in a mergers and acquisitions transaction to get a ***base gauge of the value*** it would cost to



purchase the company's deals, and for the most part, the ***lower the EV to Sales proportion is, the more alluring or underestimated the company is*** believed to be by possible procuring parties. A ***company can basically be purchased by its own money if the EV/Sales measure is negative – implying that the money in the company is more prominent than the market capitalization and obligation structure.***

Book Value

Valuation dependent on the book value technique ***works best for those companies that don't have intangible resources and significant resources***, for example, intellectual property, trade secrets, brand value, and the competency of the managers and officers are ignored in the valuation. The book value will likewise rely upon the various bookkeeping rehearses the company uses. Liabilities are frequently in question when arranging a valuation in a mergers and acquisitions transaction when using book value.

Liquidation Value

Liquidation value is the ***estimation of the sale of assets at one point in time employing the use of an appraiser.*** Normally this strategy will be ***used for firms in money related pain or those that have a questionable future.*** Regularly, it is hard to get an agreement between the parties as liquidation values tend to change with the appraiser, and such factors should be mulled over, for example, the physical state of the assets, or at times, the age of the assets. Moreover, a few appraisers may overlook the estimation of certain intangible assets.

Discounted- Cash-Flow Method

The rule behind this kind of valuation is that a ***business' worth depends on the company's capacity to produce and develop its income for the suppliers of the capital.*** It gives an estimation of the organization's absolute worth, ***based on its Free Cash Flows*** to the firm limited at the Weighted Average Cost of Capital. The FCFs of the firm are the cash flows from operations accessible to every single capital supplier, net of the necessary capital investments important to keep up the organization as a going concern. ***The WACC mirrors the hurdle rate that suppliers of capital require*** based on the hazard they face from putting resources into the organization. ***The equity value per share that is, the value accruing to the common shareholders is given by the operating value of the company minus the value of any claims on the company's cash flows by debt holders, preferred shareholders, non-controlling interest shareholders, and any contingent claimants.***

Industry Rule of Thumb

In some sectors, the buying and selling of companies is common, therefore leading to the development of industry-wide rules of thumb. ***Taking account of industry relevant factors*** (such as turnover, customer numbers, number of outlets/sales channels) a buyer will work out what the company is worth to them. While it would be unusual for a company to be valued purely by reference to a rule of thumb, such analysis can be useful to support/disprove any analysis where a company has been valued under another methodology.

Art of Negotiation

The deal of a Mergers and Acquisition doesn't lie solely on the quantitative valuations churned out, but also in the art of negotiations. As an art, ***negotiation involves the judgement and interpretation of data; evaluation of transaction dynamics; and selling the story and crafting the deal at the lowest/highest possible price from the point of a buyer or seller respectively.*** Negotiation theory has evolved over the years.

There are **four basic tenets:**

(1) separate the basic impulse of the person from the problem,
(2) focus on the other side's interest rather than their position
(3) work cooperatively to find win-win options, and
(4) establish agreed standards to evaluate these possible solutions.

Additionally, it should be ensured that negotiation is carried forward step-by-step, so all parties have a proper chance to put their point forth. Moreover, time should be managed well to avoid fatigue, and negative emotional situations.

Strategic vs Financial Buyers

M&A deals are made for various reasons and the motive underlying a particular transaction divides the buyers into two broad categories- Strategic Buyers and Financial Buyers.

Strategic buyers are usually a competitor in the same industry or an adjacent or close one. This large company ***buys smaller companies to acquire 'strategic synergies' so that the whole becomes greater than the sum of the parts.*** *Example- Facebook acquiring Instagram and WhatsApp*

Financial buyers may be a private equity firm, a venture capital firm or any institutional investor who ***makes a deal for the returns they will reap from such purchase.*** *Example- Berkshire Hathaway acquires various companies to sell them in future.*

Key differences

Stratergic Buyers	BASIS	Financial Buyers
To buy at he lowest price and finally selling it for the maximum price possible.The exit strategy that they may opt for can be Initial Public Offering (IPO) i.e. making the company public or selling the company on a future date. Their decision of which company to buy is based on their expected future earnings	Interest/Aim	Their interest in buying a company may be growth opportunities, reducing costs, better distribution channels, entering new market segments, better technology, production process, suppliers, customers or work-force
Strategic buyer buys a company for long term value creation	Duration	Add a a financial buyer makes a purchase for 5-7 years in which he tries to make the company a more attractive investment for the future acquirer
Add a a strategic buyer is inexperienced and the process is more difficult in such case asthere is a need to integrate the operations of both the entities	Efficiency	The financial buyers are specialists in M&A deals and follow specific steps of research and analysis before getting into one. Hence, their estimates are more precise and the process of transition more smooth
The strategic buyer is more likely to change the personnel of the acquired company as he is deeply interested in the efficient working of the company.He may also lay off employees in overlapping areas or to reduce costs	Personnel	In the case of a financial buyer, the management and employees are more likely to be retained as the buyer generally finds a company with competent management
The strategic buyer is ready to pay a high premium for the likely synergies they will achieve from the merged venture	Value	A financial buyer aims to pay the lowest possible price

Which is a better deal?

Be convinced or not, the answer to the question "which is right?" is not always as clear as it might seem. Whether a strategic buyer or a financial buyer is healthy for a particular company depends primarily on the seller's goals in selling the business.