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Corporate Strategy – Mergers & Acquisitions (M&A)

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Oral Exam!

Corporate Strategy: organic vs. inorganic growth

- Changes in the product scope and/or in the geographical scope can be made by:
  - **Internal (organic) growth**, i.e. the company invests to develop internally (by buying assets and hiring people) the resources and competences needed to launch the new products or to enter in a new geographical market
  - **External growth**, i.e. the company modifies its boundaries by acquiring existing companies **(M&A).**

acquisition : get the majority
merger: merge together to create a new entity

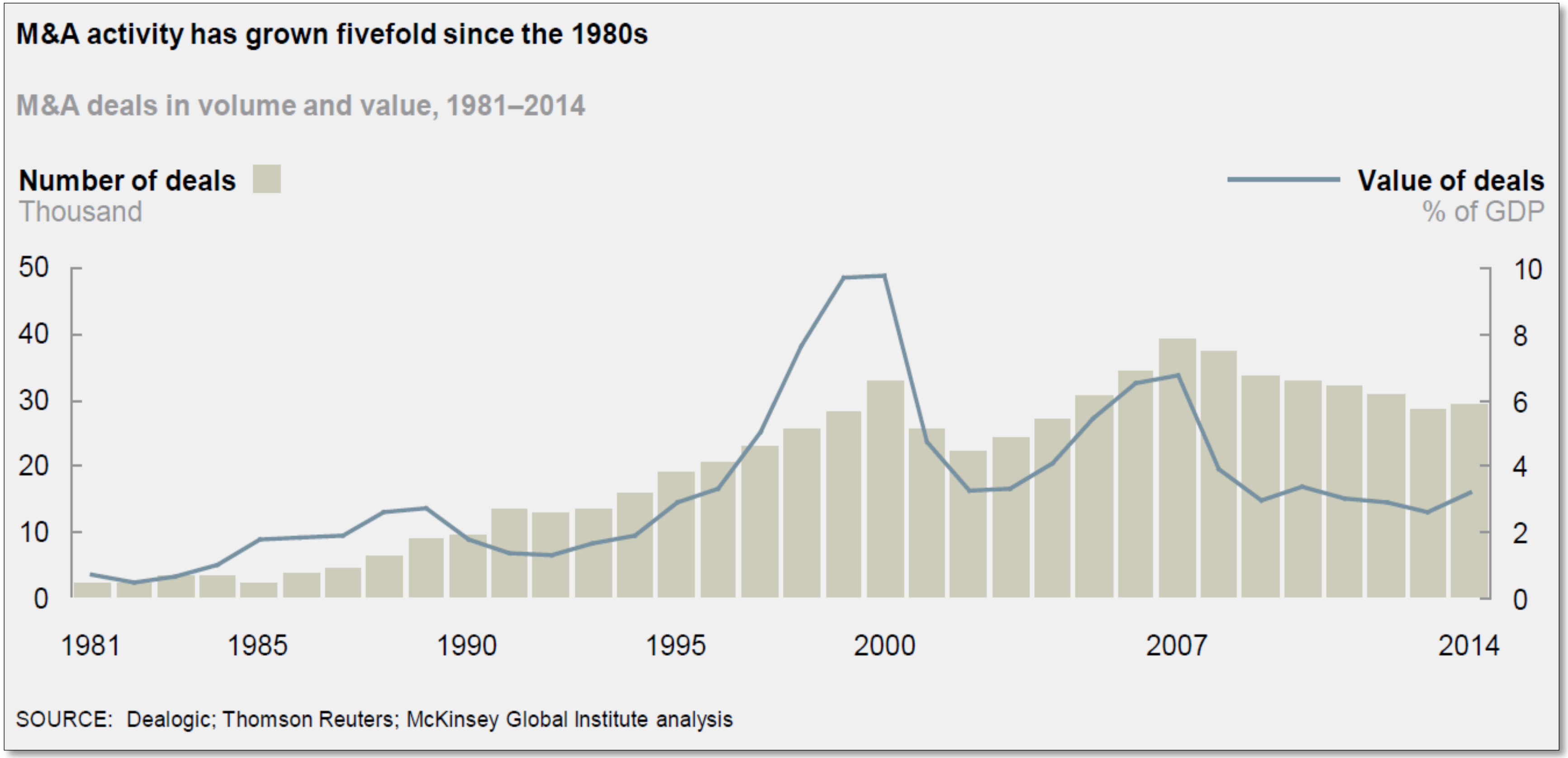
M&A: examples

- Faced with the need to muscle out competitors, companies are increasingly pursuing inorganic growth as a strategy for capturing new markets, adding new business lines, and scaling up quickly. The corporate world has experienced spikes of mergers and acquisitions activity in the past, but nothing compares to the volume of megadeals in the past two decades. In 1990, there were nearly 10,000 M&A deals with a combined value equivalent to 2 percent of world GDP. Since 2008, there have been some 30,000 deals a year totaling roughly 3 percent of world GDP.

- The total value of worldwide deals in 2014 was $3.5 trillion, up 25 percent from the previous year and its highest level since the global financial crisis. Ninety-five deals exceeding $5 billion were announced in that year alone.

Source: MGI Global Competition, Full Report, 2015

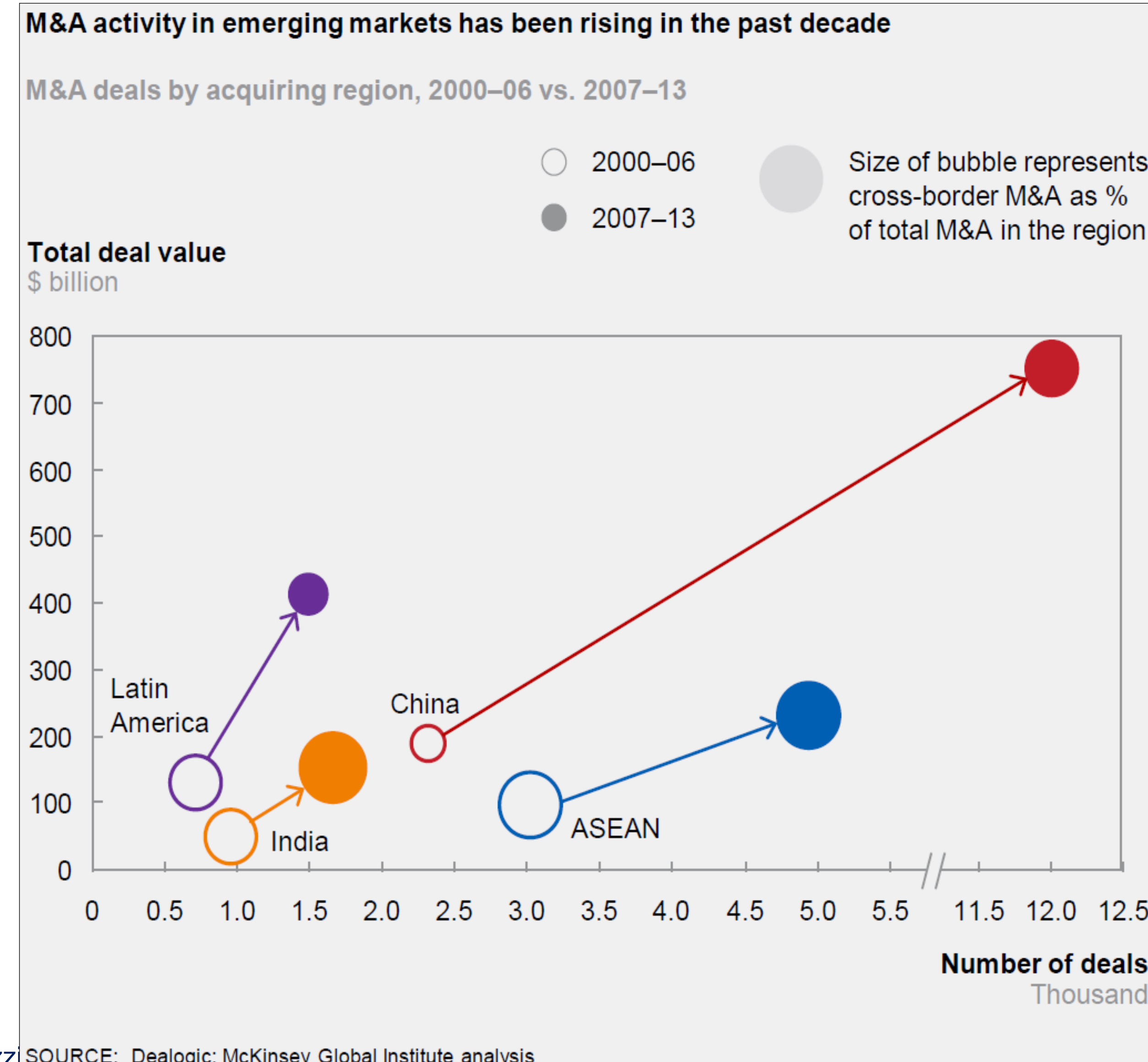
M&A: examples



M&A activity has grown fivefold since the 1980s
M&A deals in volume and value, 1981–2014
Number of deals
Thousand
Value of deals
% of GDP
50
40
30
20
10
0
10
8
6
4
2
0
1981
1985
1990
1995
2000
2007
2014
SOURCE: Dealogic; Thomson Reuters; McKinsey Global Institute analysis

M&A: examples

- Emerging-market companies have been significant players in this trend:



M&A: examples

Having grown to significant size at home, Chinese, Indian, and other emerging-market companies are now using M&A strategies to expand their global presence. India's Sun Pharmaceutical, for example, has made a stream of acquisitions since the 1990s to become one of the world's largest generic drug companies. The Tata Group, based in Mumbai, encompasses 19 companies with more than 50,000 workers in the United Kingdom alone, making it one of the country's largest private-sector employers. Brazil's JBS has become the world's biggest meat producer through a series of acquisitions, including the purchase of US-based Swift & Company and Pilgrim's Pride. Chinese firms, in particular, have embarked on a wave of global acquisitions. In 2013, Chinese firms completed 198 overseas deals worth $59 billion, accounting for one-third of their total acquisitions that year. Over the past four years, Chinese firms' share of global deal value has exceeded their share of global revenue by almost 30 percent, an indicator of their aggressive expansion. Consider just a few of the headline deals in recent years: Zhejiang Geely Holding Group Co. acquired Swedish automaker Volvo; Shuanghui International now owns US-based Smithfield Foods, the world's largest pork producer and processor; China National Offshore Oil Corporation bought Canadian oil and gas producer Nexen; and Lenovo recently bought Motorola Mobility.

Source: MGI Global Competition, Full Report, 2015

Types of M&A Transactions

STRATEGY	ACTION	CONSIDER PURSUING IF
ACQUISITION	ACQUIRE A CONTROLLING STAKE IN A COMPANY (TARGET)	* THE OPPORTUNITY IS NOT GOING TO LAST * THE TARGET IS UNDERVALUED * IT WILL EASE ENTRY TO A NEW MARKET * SKILLS AND COMPETENCIES ARE COMPLEMENTARY * THE TARGET FITS AND ENHANCES THE COMPANY'S PORTFOLIO
JOINT VENTURE	JOIN FORCES WITH ANOTHER COMPANY	* IT WILL EASE ENTRY TO A NEW MARKET * SKILLS AND COMPETENCIES ARE COMPLEMENTARY * YOU ARE NOT READY TO COMMIT TO A FULL BLOWN ACQUISITION * ADDITIONAL RESOURCES ARE NEEDED FOR A COMPELLING PROJECT
DIVESTITURE	SELL A WHOLE BUSINESS UNIT	* THE UNIT NEEDS MORE RESOURCES OR CAPITAL THAN YOU CAN PROVIDE

finance desicion, tax reason, managerial, showing the market,

Advantages of Acquisitions

Once a company has decided to change corporate scope, acquisitions have at least three advantages compared with internal development:

1. They are faster to accomplish than internal development, because the company acquired is typically "up and running".
2. Compared with internal development, more information is available to the prospective acquirer to evaluate the move.
3. A certain percentage of internally developed new businesses fail. By acquiring a going concern, the acquirer does not need to pay for any of the failures along the way.

Approaching the Deal

Corporate managers can approach acquisition transactions either as buyers or sellers, and in each case they face a number of alternative choices:

- If they are on the **buying side**: they can go for a friendly or for a hostile deal: they can offer to pay the consideration in cash, or in shares (or a combination of the two); they can seek total ownership (100% of the shares) or simple majority.
- If they are on the **sale side**: they can run an auction or pursue a specific buyer; they can sell all the shares or remain as minority shareholders; they can sell to the SBU's management, usually backed up by a financial investor; they can distribute the shares in the SBU to the shareholders ("spin off")

Four Critical Decisions

There are four critical decisions that make or break a deal:

1. How should you pick your targets? the portfolio, corporate str.or internal analysis
2. Which deals should you close?
3. Where do you really need to integrate?
4. What should you do when the deal goes off track?

D. Harding & S. Rovit, **Mastering the Merger**,
Harvard Business School Press, September 2004

Reasons for Making Aquisition

Acquisitions

- Increase market power
- Overcome entry barriers
- Cost of new product development
- Learn and develop new capabilities
- Reshape firm's competitive scope
- Increase diversification
- Lower risk compared to developing new products

Reasons for making Aquisition?

1. Increased Market Power

standard oil =>

Factors increasing market power:

- when a firm is able to sell its goods or services above competitive levels, ***or***
- when the costs of its primary or support activities are below those of its competitors;
- usually it is derived from the size of the firm and its resources and capabilities to compete.

Market power is increased by:

- horizontal acquisitions;
- vertical acquisitions;
- related acquisitions.

- **Horizontal acquisition**: acquisition of a target company that produces other products than the acquiring company.
- **Vertical acquisition:** the target company is related to the acquiring company operation system, like a supplier
- **Related acquisitions:** acquisitions that are strictly related to the business. For example if the acquiring company wants to include a direct competitor within its boundaries

Reasons for making Aquisition:

2. Overcome Barriers to Entry

Barriers to entry include:

- economies of scale in established competitors;
- differentiated products by competitors;
- enduring relationships with customers that create product loyalties with competitors.

Acquisition of an established company:

- may be more effective than entering the market as a competitor offering an unfamiliar good or service that is unfamiliar to current buyers

Cross-border acquisition.

Reasons for making Aquisition:

3. Cost of New Product Development

matel => child toy barbie
invest in educational learning
they bought a ML company

Significant investments of a firm’s resources are required to:

- develop new products internally;
- introduce new products into the marketplace.

Acquisition of a competitor may result in:

- lower risk compared to developing new products
- increased diversification;
- reshaping the firm’s competitive scope;
- learning and developing new capabilities;
- faster market entry;
- rapid access to new capabilities.

Reasons for making Aquisition:

4. Lower Risk Compared to Developing New Products

Microsoft acquiring game company

An acquisition’s outcomes can be estimated more easily and accurately compared to the outcomes of an internal product development process.
Therefore managers may view acquisitions as lowering risk.

Reasons for making Aquisition:

5. Increased Diversification

It may be easier to develop and introduce new products in markets currently served by the firm.
It may be difficult to develop new products for markets in which a firm lacks experience:

– It is uncommon for a firm to develop new products internally to diversify its product lines;
– Acquisitions are the quickest and easiest way to diversify a firm and change its portfolio of businesses.

Reasons for Making Acquisitions:

6. Reshaping the Firms' Competitive Scope

Firms may use acquisitions to reduce their dependence on one or more products or markets.
Reducing a company's dependence on specific markets alters the firm's competitive scope.
Once a company has decided to change corporate scope, acquisitions have at least two advantages compared with internal development:

1. They are faster to accomplish than internal development, because the company acquired is typically "up and running".
2. Compared with internal development, more information is available to the prospective Acquirer to evaluate the move.

Reasons for Making Acquisitions:
7. Learning and Developing New Capabilities

Dysney & Pixar

Acquisitions may gain capabilities that the firm does not possess.
Acquisitions may be used to:

- Acquire a special technological capability;
- Broaden a firm's knowledge base;
- Reduce inertia.

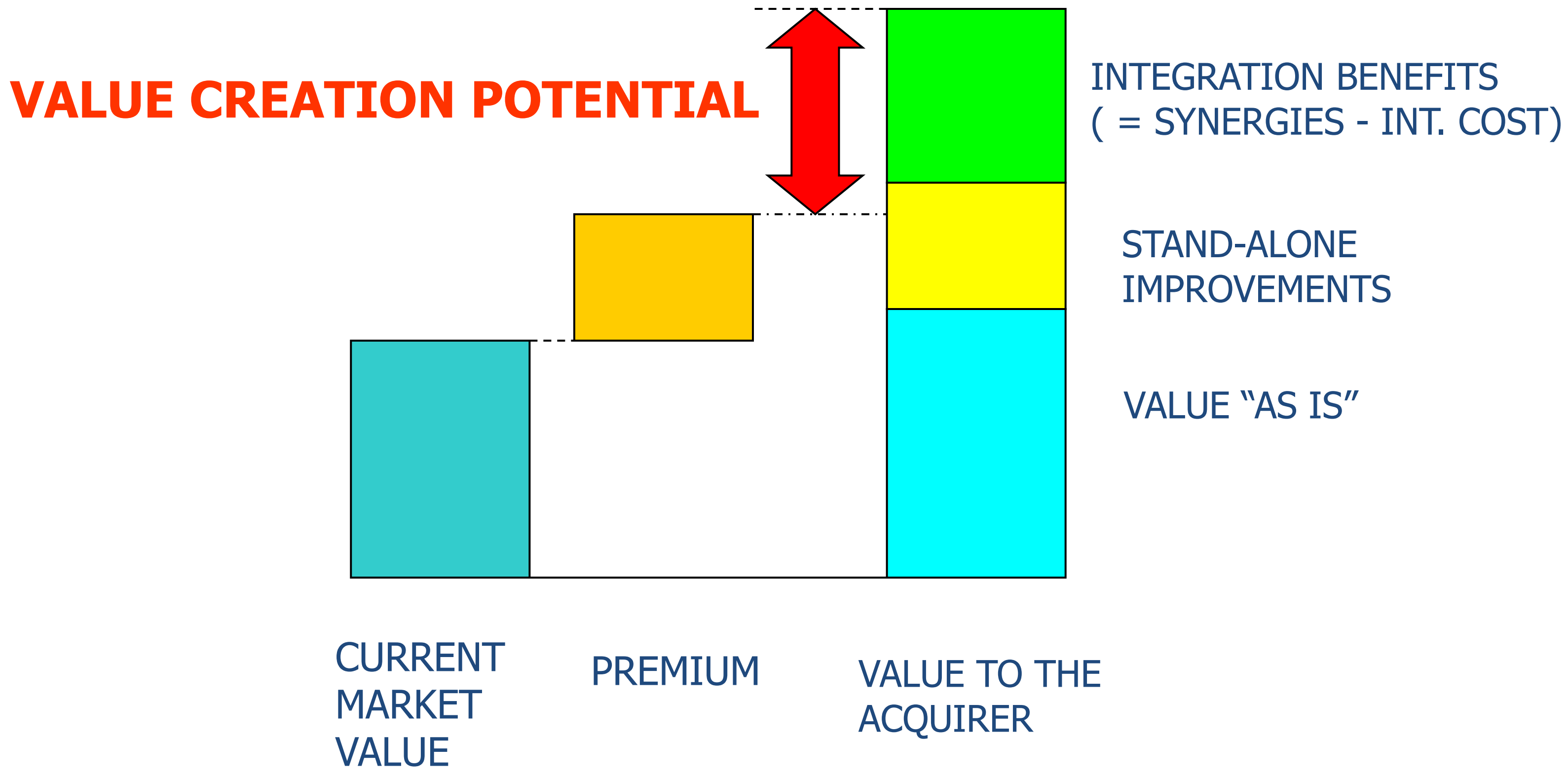
Value Creation in Aquisition

Companies engage in M&A activity with the objective of creating value for their shareholders.

The value can be generated through **stand-alone improvements** and **synergies**.

However the majority of acquisitions fail to create value, and many of them destroy shareholder value.

Value Creation Potential



Main Types of Synergies (1/2)

Cost Saving: this is the most common type of synergy and the easiest to estimate, and they are also labelled as ***"hard synergies"***. They often come from eliminating jobs, facilities, and related expenses that are no longer needed when functions are consolidated, or they come from economies of scale in purchasing.

Revenue Enhancements: it is sometimes possible for an Acquirer and its Target to achieve a higher level of sales growth together than either company could do on its own. In fact, sometimes the Target brings a superior or complementary product to the more extensive distribution channel of the Acquirer. In other instances, a Target's distribution channel can be used to escalate the sales of the Acquirer's product. Revenue enhancements are notoriously hard to estimate and they are often described as ***"soft synergies"***.

Main Types of Synergies (2/2)

Process Improvements: they occur when managers transfer best practices and core competencies from one company to the other. That results in both cost savings and revenue enhancements. The transfer of best practices can flow in either direction.

Financial Engineering: an example is when a transaction allows the Acquirer to refinance the Target's debt at the Acquirer's more favourable borrowing rate, without negatively affecting the Acquirer's credit rating.

Synergies play a role in: Valuation, Negotiation, Integration

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The synergies between the Acquirer and the Target are specific to each Acquirer. The value of synergies is normally «split» between the two as part of the price ***negotiation***.

The quantification of synergies is part of the ***valuation*** process.

Synergies can materialise only through a successful ***integration***.

Problems With Acquisitions

Acquisitions

- Integration difficulties
- Inadequate evaluation of Target
- Large or extraordinary debt
- Inability to achieve synergies
- Too much diversification
- Managers overly focused on acquisitions
- Resulting firm is too large

Problems With Acquisitions

1. Integration Difficulties

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Integration challenges include:

- melding two disparate corporate cultures;
- linking different financial and control systems;
- building effective working relationships (particularly when management styles differ);
- resolving problems regarding the status of the newly acquired firm's executives;
- loss of key personnel weakens the acquired firm's capabilities and reduces its value.

Problems With Acquisitions

2. Inadequate Evaluation of Target

Evaluation requires that hundreds of issues be closely examined, including:

- financing for the intended transaction;
- differences in cultures between the acquiring and target firm;
- tax consequences of the transaction;
- actions that would be necessary to successfully melt the two workforces.

Ineffective due-diligence process may result in paying excessive premium for the target company.

Problems With Acquisitions

3. Large or Extraordinary Debt

Firm may take on significant debt to acquire a company. High debt can:

- increase the likelihood of bankruptcy;
- lead to a downgrade in the firm's credit rating;
- preclude needed investment in activities that contribute to the firm's long-term success.

Problems With Acquisitions

4. Inability to Achieve Synergies

Synergies exist when assets are worth more when used in conjunction with each other than when they are used separately.

Firms experience transaction costs (e.g., legal fees) when they use acquisition strategies to create synergies. Firms tend to underestimate indirect costs of integration when evaluating a potential acquisition.

Problems With Acquisitions
5. Too Much Diversification

Diversified firms must process more information of greater diversity.

Scope created by diversification may cause managers to rely too much on financial rather than strategic controls to evaluate business units' performances.

Acquisitions may become substitutes for innovation.

Problems With Acquisitions

6. Mangers Overly Focused on Acquisition

Managers in Target firms may operate in a state of virtual suspended animation during an acquisition. Executives may become hesitant to make decisions with long-term consequences until negotiations have been completed.

Acquisition process can create a short-term perspective and a greater aversion to risk among top-level executives in a Target firm.

Problems With Acquisitions

7. Too Large

Additional costs may exceed the benefits of the economies of scale and additional market power.
Larger size may lead to more bureaucratic controls.

Formalized controls often lead to relatively rigid and standardized managerial behavior.
Firm may produce less innovation.