Mergers and Acquisitions

**Changes in Ownership and Control**

Merger and acquisition activities are based on capital allocation decisions often made in response to the changes in a company’s operating environment. Consequently, these activities are part of the corporate change process, a process of capital deployment and redeployment involving changes in ownership and control.

The way in which the change of ownership or control is accomplished depends on the result desired.

Type Definition Details

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| **Merger** | **A type of acquisition in which two or more business entities are combined into one** | **Assets and liabilities of the two companies are merged and the target ceases to exist** |
| **Acquisition** | **The purchase of one company’s stock by another company** | **The buyer continues to exist; the target may continue to exist as a wholly or partly owned subsidiary** |
| **Consolidation** | **A combination of two or more business entities into a new entity** | **Both buyer and target cease to exist and a new combined entity is formed with the combined assets and liabilities of the two** |
| **Takeover** | **A change in the control of a company through merger, acquisition or some other type of transaction** | **Takeovers can be either friendly (supported by management) or hostile (resisted by management and board of directors of the target)** |
| **Proxy Contest** | **A strategy for gaining control of a company by obtaining the voting rights of the target’s shareholders** | **Not an acquisition but can facilitate and acquisition; it allows the buyer to avoid paying a premium for the target** |
| **Tender Offer** | **A purchase offer made directly to the shareholders of the target, typically at an offer price greater than the current market price** | **Not an acquisition but can facilitate an acquisition** |
| **Divestiture** | **The disposal or sale of part of a company** | **The seller gives up all ownership in the divested portion** |
| **Spin-off** | **The creation of a new company from part of an existing company** | **Shareholders of the original company typically receive shares in the new company in the same proportion as their ownership of shares in the original company** |

Comparison of the Result of a Merger and Acquisition and a Consolidation.

Assume Company A is the acquirer and Company B is the target

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| --- | --- | --- |
| Merger | Acquisition | Consolidation |
| Company A  (Company A + Company B) | Company A | Company C  (Company A + Company B) |
|  | Company B  (Subsidiary of Company A) |  |

Although the terms “merger” and “acquisition” refer to different types of transactions, they are often used interchangeably.

One method of achieving a takeover is through a proxy contest. The proxy contest by itself is not an acquisition; however, it may be used to facilitate an acquisition.

Acquisitions are sometimes described according to the business nature of the acquisition; that is, according to whether or not the buyer and the target operate in the same business area.

**A horizontal acquisition is a combination of two companies in the same line of business. The 2003 merger of St Paul Companies and Travelers Property Casualty Corporation, which was valued at $16.4 billion, set a new record for the combined valuation of a horizontal acquisition in the property-casualty industry**.

**A vertical acquisition is a combination of two companies involved in related lines of business but different stages of production. Examples of vertical acquisitions include an insurer acquiring an insurance agency or a primary insurer acquiring a reinsurer.**

**A Conglomerate acquisition is a combination of two companies in unrelated lines of business. Berkshire Hathaway’s $23.5 billion acquisition of General Re in 1998 is an example of a conglomerate acquisition**.

**Reasons for Acquisitions**

The overriding business reasons for acquisitions involve reduction of costs and more effective use of resources, both of which should positively affect the value of the company concerned. This increase in value benefits the shareholders, and companies typically cite increasing shareholder value as the reasons for the transaction. **These reasons for acquisition can be viewed from the perspective of corporate finance to ascertain their true implications for shareholder value:**

* **Cost**
* **Synergies**
* **Competitive advantage**

**Cost Savings**

Organizations consistently seek ways to reduce costs as a means of increasing profits. There are several ways in which an acquisition can lead to cost savings, including efficiencies, tax advantages, and reduced cost of financial distress.

* **Efficiencies – An acquisition may lead to more efficient use of a company’s financial resources, either by way of revenue efficiencies or cost efficiencies.**
  + **Revenue efficiency – In the context of acquisitions, a measure of the extent to which a company’s revenues can be increased by combining the company with another entity or entities. A company is considered to have achieved revenue efficiency when its revenues cannot be increased, holding economic inputs constant by combining the company with another entity or entities.**
  + **Cost efficiency – In the context of acquisitions, a measure of the extent to which a company’s costs can be reduced by combining the company with another entity. A cost-efficient company has obtained both technological and allocational efficiency.**
* **Tax Advantages – Acquisitions can enable an organization to be more tax efficient. Tax efficiency can be achieved by reducing income taxes through increasing the level of debt, increasing cash flows from recovery of taxes from acquired net operating losses, and reducing income on which tax is calculated through the investment of depreciable assets.**
* **Reduced Cost of Financial Distress – Debt holders and creditors reducer their credit risk because the debt risk of the combined company is lower. Because of this reduced risk, the company can gain access to more favorable credit and contract terms, increasing net operating cash flow. The company can also avoid the regulatory costs that come with financial distress**.

**Synergies**

“Synergy” implies that some mutual advantage is achieved when two companies are combined. In that sense, any increase in net cash flows resulting from a business combination reflects synergies. In a narrower sense, synergy is thought of as the benefits generated from combining complementary activities. The strengths of one company in certain areas may compensate for the weakness of another company in those areas.

* **Savings from economies of scale are expected in horizontal acquisitions and are size driven, leaving the range of products and services unchanged. If one or both of the companies have excess capacity that will be more fully used when the two companies combine, then reduced capital needs and associated capital costs will result.**
* **Savings from economies of scope are expected in vertical acquisitions and result from broadening the range of products and services offered. Cost savings can come from the use of shared resources, improvements in a company’s competitive position and additional revenue opportunities**.

**Competitive Advantage**

In an efficient market, the market price of a company’s shares reflects all information about the company and indicates the value of the company. However, not all investors have the same information. **An increase in market concentration is the desired outcome of some horizontal acquisitions. When few companies compete in a line of business or market, acquisitions are more likely to increase the market power of the combined company, which enables the company to influence price, product offerings, and contract terms.**

**Acquisitions Gains and Costs**

An economic gain results from an acquisition when the Companies combined are more valuable together than apart. Companies are worth more together only if additional net cash inflows result from the combined companies.

**The value of the economic gain (G) can be calculated as:**

**G = V ab – (Va + Vb)**

**Where: Vab = Value of two companies combined**

**Va = Value of company A alone (not considering the acquisition) and**

**Vb = Value of Company B alone (not considering the acquisition)**

Acquisition makes economic sense only when G is greater than zero. Although G is based on the incremental cash flow from the business combination, it is necessary to determine the value of the target company, Vb, in order to establish an offer price.

The incremental cash flows result from changes in revenues, expenses, taxes, financing costs, and agency costs**. If Companies A and B are publicly traded, then their market values as separate entities are directly observable. If Company A or B is a privately held company, the market values can be estimated using valuation techniques, such as discounted cash flow valuation model**.

It is important to remember that the discount rate used to find the present value of the incremental cash flow should reflect the risk of these cash flows, which might be different from the discount rates of either Company A or Company B as separate entities.

The acquisition price determines how the economic gain is shared between the buyer and the target. If the acquisition price demanded exceeds the value of the target as a separate entity by more than the economic gain, then the buyer will not have an economic incentive to make the acquisition.

In an acquisition financed with cash, the acquisition price is simply the amount of cash paid for the target firm. For example, if Va = $300M, Vb = $100M, and Vab = $450M. then G = $50M. If Company A pays $120M in cash to the owners of Company B, the shareholders of company B gin $20M (120M- $100M = $20M). The remaining $30M of the $50M gain goes to the shareholders of Company A.

The acquisition price in a stock acquisition depends on the market price per share of stock in the combined entity after the merger.

Suppose Company A has 3M shares outstanding (worth $100 each) and that it issues an additional 1.2M shares to purchase company B. After the two companies combine, the combined value of the two companies is $450M and there are 4.2M shares outstanding.

The shares held by the former owners of Company B are worth $128.6M [(1.2M /4.2N) x $450M = $128.6M], and the shares held by the former owners of Company A are worth $321.4 N ($450M - $128.6M = $321.4M. Consequently, when stock (rather than cash) is used to finance the acquisition, the gain to Company A shareholders is $21.3M, and the gain to Company B shareholders is $28.7M, therefore, the gain to Company A shareholders is lower (the gain was $30M when the acquisition was financed with cash), and the gain to Company B shareholders is higher.

**To make the gains equal whether stock or cash is the transaction currency, the number of shares issued in an acquisition financed with stock must reflect the benefits of the acquisition by using the expected share price once the acquisition has been completed**.

The market value of a publicly traded stock should be used cautiously to estimate the cost of an acquisition because this value may reflect the market’s probability assessment of a successful merger. An advantage to the acquiring company of a stock-financed acquisition is that, if the market value of stock in the combined entity declines after the acquisition, the shareholder of the target company bear part of the post-acquisition decline in value.

**Mechanics of Acquisitions**

Acquisitions present organizations with advantages and disadvantages.

To determine whether the advantages outweigh the disadvantages, these mechanics of acquisition must be considered:

**Due Diligence** – The process of examining a company’s operations, finances, and management and verifying material facts that affect company value.

An acquisition is a potential investment opportunity, and it is the risk and return trade-off that creates or destroys the value of that investment. Economic transactions have two main elements – price and terms – that must be evaluated together to assess value. The more extensive the gathering an analysis of information about the potential target, the better the buyers understanding will be of likely risks and rewards. Consequently, the buyer will be able to make a more accurate and informed valuation of the target.

**Due diligence provides a foundation for valuation analysis, deal negotiations, and the post-acquisition integration process. If performed well, due diligence can reduce legal risk exposures and thereby increase the value of the target to the buyer.** However, the costs and benefits of due diligence have to be balanced. Excessive due diligence may damage the relationship between the buyer and the target and break an otherwise attractive deal. Insufficient due diligence might fail to expose the extent of the risk and thereby produce an excessive valuation of the target.

The Sarbanes-Oxley Act of 2002 adds another level of complexity to due diligence. The increased regulatory compliance costs and harsh penalties for noncompliance have become vital considerations in acquisitions. Enhanced financial disclosures, management assessment of internal control systems, and certification of financial statements by the chief executive officer are some of Sarbanes-Oxley that must be taken into account when combining with another entity. Consequently, weak internal controls at a target company may cause a buyer to abandon an acquisition deal.

**Tax Aspects**

An acquisition may be either taxable or tax free. If the form of payment is cash, then the shareholders of the acquired company incur a taxable gain or loss. This taxable gain or loss is the difference between the cash received and the shareholder’s tax basis in the shares sold (typically the original cost of the shares adjusted for previously recognized capital gains or losses). Shareholders of the target company may require a higher acquisition price to offset capital gains taxes. If payment is mostly in the form of shares of the buyer, then the transaction is viewed as an exchange of shares, and no capital gain or loss is recognized at the time of the exchange.

After taxable acquisition, the assets and liabilities of the acquired company are revealed, resulting in a taxable gain or loss. Depreciation on these assets is calculated based on the new values.

**Financial Aspects**

Many parties, including investors, creditors, regulators, rating agencies, and managers, rely on the financial information companies provide. Regulatory monitoring systems, especially in the banking and insurance industries, depend on periodic financial examinations and financial ratio analysis.

Publicly traded debt securities must obtain credit ratings, which are primarily based on financial statement data. Capital markets respond to announcements of accounting earnings and other accounting-based information, ultimately influencing the market perception of a company’s risk and return profile.

**One of the key areas of concern in the insurance industry is the solvency position of an insurer. Evaluating insolvency risk is a major activity of insurance rating agencies and regulators, and it depends heavily on insurers’ financial and operating information.**

A buyer will also need to ascertain whether there are any potential restrictions on financial operations imposed by existing agreements. For example, loan agreements frequently contain loan covenants. Loan covenants can include restrictions on dividends and other operating and financing decisions based on the financial position and performance of the debtor.

**In many instances, a buyer is willing to pay more for a company than the market value of the target company’s net worth according to its recorded asset. This is because the acquired company many have franchise value related to the brand name, expertise (human assets), technology, or other sources of competitive advantage beyond the fair value of the tangible and intangible assets recorded in its financial statements**.

**Takeover Defenses for Mergers and Acquisitions**

Organizations use several defensive tactics to prevent a takeover

Tender offers and proxy contests can help a company to launch a hostile takeover. Although hostile takeover attempts occur less frequently in the insurance industry than in other industries (because regulatory approval is needed for a change of control), they do occur. A target can use several defensive tactics to prevent a takeover.

**Targeted Repurchase**

One type of hostile takeover comes from a corporate raider – that is, an individual or a company that is attempting to acquire a controlling interest in the target in order to launch a hostile takeover and replace existing management. Another type of hostile takeover, referred to as a “bear hug”, occurs when a hostile bidder makes an offer at a premium large enough to guarantee shareholder support, even in the face of opposition from the target’s board of directors. The board is legally obligated to the shareholders to accept a sufficiently generous offer.

**Once the raider has 5% of the voting shares in a company, the raider must report its ownership interest to the Securities and Exchange Commission (SEC) and to the target. A target company may initiate a targeted repurchase from the raider, usually at a substantial premium above the prevailing market price, in order to terminate the takeover attempt.** The payments made to the potential buyer are called greenmail. Giving in to greenmail can lead to further unfriendly takeover attempts by other corporate raiders hoping to collect greenmail.

**“White Knights” and “Shark Repellents”**

**Another defensive tactic is for the target to find a friendly buyer, known as a white knight. Although the target will still be acquired, the buyer is a company that is acceptable to the target**. Alternatively**, the target can try to make the acquisition more difficult of costly to the bidder by using one or more of these common defense tactics, collectively referred to as “shark repellents”**

* **Golden parachute** – a provision in an executive’s employment contract that specifies that he or she will receive a large payoff, such as a severance pay, immediately vesting of stock options, and enhanced retirement benefits, if his or her contract is terminated after the company is acquired.
* **Super majority** – a company can amend its bylaws to require that a super majority approve any acquisition attempt. For example, 67% vs 50%
* **Staggered board** – a company can require that a minority fraction, such as 1/3 of the board members is elected each year. This rotating board make it more difficult for a bidder to obtain enough board votes to approve an acquisition
* **Poison pills –** poison pill clauses give existing shareholders the right to purchase additional shares at a substantial discount or to redeem their shares at a significant premium when a buyer acquires a specified percentage of shares, typically 10% of voting common stock. A flip-in provision can give the holder the right to buy additional shares in the target at a bargain price, diluting the buyer’s ownership shares, as well as increasing the cost of acquiring additional shares.
* **Poison puts** – poison put options give bondholders the right to demand debt repayment, possibly at a premium, if there is a change in control as a result of a takeover. This provision protects the company’s existing bondholders from devaluation and causes immediate cash drain for the buyer.
* **Crown jewel** – a target might sell or threaten to sell some key assets (crown jewels) to avert a takeover.
* **Lockup** - with a lockup, a friendly buyer is given the option to purchase certain key assets or stock of the target in the event of a hostile takeover attempt.