[Academic Script]

Mergers and Acquisitions

Subject:	Business Economics
Course:	B.A., 3rd Semester, Undergraduate
Paper No. & Title:	Paper – 303 Business Finance
Unit No. & Title:	Unit - 5 Mergers and Acquisitions
Lecture No. & Title:	Lecture – 3 Mergers and Acquisitions

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1. Introduction

In today's fast-paced world,everyone is looking for faster and cheaper ways of doing things better. With the increasing of business competitions and the economy heading towards globalization, every company has to look uponthe survival of business organisation. In 20th century, only Financial Management is enough to survive or to grow but if the company wants to become compatible with today's ultra-modern world, it must have to use the Financial Management as well as Strategic Management.

Now-a-days, the usage of some new strategic tool like Mergers, Acquisitions, Takeovers, contraction strategies, Corporate control have become an integral part of new strategic paradigm in the corporate world. These methods are played an important role in achieving external growth of a number leading companies the world over.

There are some confusion and disagreement regarding the precise meaning of terms related to Mergers and Acquisitions. Let us clarify it:

- **Mergers**

According to the Oxford Dictionary "Merger" means "combining of two companies into one". In pure sense, a merger happens when two firms, often of about the same size, agree to go forward as a single new company rather than remain separately owned and operated. However in practice, actual mergers of equals do not happen very often. That is the reason that the meaning of terms related to mergers are varied according to the deal's terms.

The term Merger refers to a situation where one or more existing companies combine its business operationsand may merge with any existing company or may merge to form a new company. All the existing company merge its identity into new merged company by transferring all their assets and liabilities and all the shareholders of the existing company receive shares of new merged company in exchange for the shares held by them as per the agreed exchange ratio.

- **Acquisition**

The term 'Acquisition'refers to acquiring of effective working control by one company over another company where acquiring company takes over the ownership of other companies and continues their operation with its own operations.

Acquisition may be defined as an act of acquiring effective control over assets or management of a company by another company without any combination of businesses or companies.

A substantial Acquisition occurs when an acquiring firm acquires substantial quantity of shares or voting rights of the target company. Thus, in an Acquisition two or more companies may remain independent, separate legal entity, but there may be change in control of companies.

An Acquisition may be either Friendly or Hostile Acquisition,

i. **Friendly Acquisition**

Friendly Acquisition takes place when the management of acquiring company and Target Company mutually and willingly negotiate or cooperate with one another.

ii. **Hostile Acquisition**

Hostile Acquisition takes place when the management of acquiring company forces target company unwillingly to be bought the business where generally target companymay not agree with the tender offer or may not having a prior knowledge of the offer.

2. Strategy adoption of M&As

A comprehensive list of motives propelling Mergers and Acquisitions activities is although difficult to draw up, the usual motives or reasons behind the strategy adoption of M&As are here:

1) **Economies of scale:**In a layman's language, more the products, more is the bargaining power. This is possible only when the companies merge or acquired. It is same as eliminating duplicate departments or operations and combines them into one thereby to lowering the product cost and increasing the product range of the company to increase profit.

2) **Acquiring market share and market power:**This motive assumes that the company will be absorbing major competitors by using the techniques of mergers and acquisition and capture their product market by market shares and market power.

3) **Technological motive:** Technology plays an important role as a driver in Mergers and Acquisitions strategy. Generally mediocre or inferior technology company prefers to merge with improved or superior technological company.

4) **Corporate synergy:** corporate synergy works on the assumption that the combined firm is more valuable than the sum of the individual firms. It suggest to use of complimentary resources available by merging or acquiring the company in such a manner that it may lead to generate either in the form of revenue enhancement or in the form of saving costs.

5) **Tax Avoidance:** Many times mergers and acquisitions techniques are adopted to save the tax. When the profitable company acquires the business of loss-making company, it is planned merger to set-off and carry forward the losses of loss-making company against the profits of the profit making company.

6) **Geographical or other diversification:** Geographical diversification is one of the potential reason of the mergers and acquisition. Sometimes merger takes place either to reduce geographical boundaries or to increase distribution channel to push common sales of the product.

7) **Growth:** Mergers and Acquisitions strategy is demonstrated tool to grow the company externally. It provides ways to throw off cash flows beyond its internal needs and also creates wealth for the business.

8) **Other reasons:**

- To improve a company's standing in the investment community as bigger firms always takes less time to raise the capital than smaller ones.
- To increase promoters' voting power.
- To eliminate the takeover threats.
- To enhance the Earning per share of the company etc.

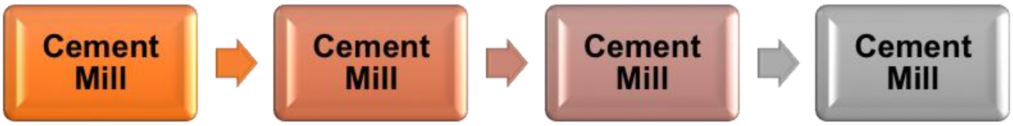
3. Types of Mergers and Acquisitions

(1) Horizontal Merger or Annexing Merger

When two or more companies produce similar product in the same industry are merging their business it is known as horizontal merger. In this case of Merger, companies which are in direct competition with each other combine its operations together to eliminate or to reduce the product market competition.

The primary reasons for acquiring or merging related businesses is the willingness to price cut, economies of scale in production, resource utilisation, market capturing or to create monopoly in the product.

Kindly look at the graph to understand the term 'similar industry'or 'Horizontal Merger'.



Horizontal Mergers produce two consequences that do not arise in either vertical or conglomerate Mergers.

1. It reduces the number of firms competing in the relevant market and
2. It eventually results into market concentration.

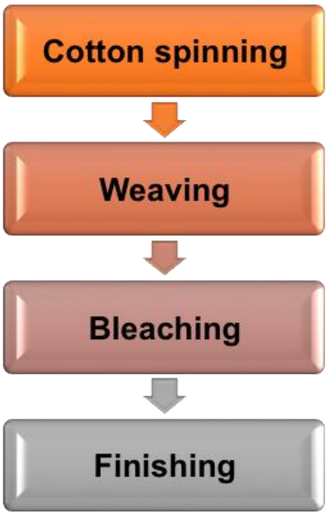
The only noticeable limitation of this type of merger is that the consumer may pay higher price for the product or services because of reduction in competition.

(2) Vertical Merger or Streaming Merger –

In the case of vertical Merger, a company acquires its upstream or downstream units. Vertical Merger is a combination of two or more firms, involved in different stages of the production cycle or distribution channel within the same industry. When company merge its operation with its supplier company, it is called backward or upstream merger and when it combines its operations with the customer company, it is called forward or downstream merger. That is the reason that vertical merger is also known as streaming merger.

The main purpose of backward vertical integration is to reduce costs of the inputs and to gain control over the production process. And primary aim of forward vertical integration is to save distribution and marketing costs by delivering the final product straight to the customers.

Let us understand vertical merger by graph mentioned here by taking example of companies involved in different stages within similar industry:



In this graph, if weaving company acquires the business of cotton spinning company it is known as backward vertical merger while if weaving company merge it operation with the business of bleaching and finishing company it is called forward vertical merger.

(3) Conglomerate Merger or Diagonal Merger:–

Conglomerate Merger takes place to achieve growth through diversification strategy. It is a combination of firms engaged in different or unrelated product lines of activity.Such type of merger is take place to add new products having no relationship with the company's current product line, technology or markets.

Allocation of the capital amongst different business entities, increasing the range of product lines, to save the tax, to provide demonstration of management power are the potential motives of the conglomerate merger.

(4) Concentric Merger –

When company concentratively thinks to merge its operation with the company having more technological or marketing synergies for their existing product, it is a type of concentric Merger.

In concentric merger company can also use any strategy from similar industry merger or diversification merger. Most of concentric mergers have been seen in the form of Hostile takeovers.

Such Mergers did not last long due to the second oil crisis in 1979 and the deep recession of early 1980s and Corporate Raiding.

(5) De-Merger –

Corporate de-Merger is one of several ways through which a firm may divest a division and improve its focus.

A de-Merger is a pro-rata distribution of the shares of a firm‵s subsidiary to the shareholders of the firm. There is neither a dilution of equity nor a transfer of ownership from the current shareholders. After the distribution, the operations and management of the subsidiary are separated from those of the parent. In American English this process is termed ‵**spin-off'**, in British English, it is known as‵De-Merger'.

4. Benefits and limitations of the merger and acquisition

Before moving on to the next topic let us quickly look on the benefits and limitations of the merger and acquisition -

Benefits of M & A are:

The deal of merger and acquisition may be beneficial to both the acquire company and the merged company in terms of either financial benefit or non-financial benefit or may be combination of both terms. But the primary benefit of Merger and Acquisition has been always obtained with the main object of a deal.

The significant benefits of the Merger and Acquisition are:

1) It uses the Economies of scale, which **reduces unit costs**.
2) It **generates greater market share** for horizontal integration, which means the business can often charge higher prices.
3) Company may **reduce tax liability if loss-making** business are purchased.
4) It **spreads risk** into many products if new product is added in product line.
5) It helps to **reduces competition** if a rival is taken over.
6) Acquire company may be **benefited by the ready factory** or refinery for its raw material, **more labour power**, **ready market** for the product etc.
7) It is **easier to raise money** if companies are merging together and make a large business.
8) It can help to **improve operating margins** and efficiencies of employees as well as management.
9) Company can **increase income** with proportionately less investment and time.
10) Deal is also **beneficial sometimes to shareholders** of merged company if merged company is making a loss.

- **Limitations of M & A are :**

1) Due to business expansion, **sometimes business becomes too large and resulting in higher unit costs** which ultimately leads to diseconomies of scale
2) **Conglomerate merger may create cultural diversity** and reduce the effectiveness of the integration.
3) **Acquisition may cause some workers redundant**, especially at management levels.
4) **Diversified merger may create conflict** of objectives between different businesses.
5) **Horizontal merger creates monopoly** which results into elimination of healthy competition from the market.
6) Concentration of economic or **market power splits** into many product, if new products are added to current product line.
7) In case of Hostile acquisitions, **unwillingness may affect the productivity** or efficiency of acquirer company.
8) Because of merger and acquisition the **size of the business** is increased, it **may ruin the business of small and medium enterprises.**

Let us move on further with the discussion of what is the Financial Considerations in case of Mergers and Acquisitions?

Consideration is something that have monetary value provided by one party to another party in exchange for a product or services. It may be in the form of cash or payment-in-kind of cash.

In case of purchasing a product, price paid in exchange for transferring ownership of goods is called consideration. In case of receiving any services, payment of bills or fees is a consideration. In case of buying an insurance policy, insurance premium paid is a consideration. In the same way while purchasing a business or part of business, purchasing company must has to pay a purchase consideration to its vendor company.

Financial consideration in case of Merger and Acquisition means the payment made by the acquirer company to shareholders of the merged company.

Acquirer Company generally prefers to pay the consideration in the form of:

1) By issuing equity shares, Preference share or any secured debt instruments of acquirer company
2) By the payment in Cash or Bank.
3) And by the combination of any of the above.

5. Technical difference of valuation and evaluation

Before we will end our discussion of today's last topic - Financial evaluation of Mergers and Acquisitions, it is necessary to focus on the technical difference of valuation and evaluation.

Valuation is a process of estimating the value for the exchange of anything having monetary worth. It is generally adopted before making any decision and consideration is paid only after the valuation. While **Evaluation** refers as an assessment process of examining or judging the decision in a precise manner that is already taken. It is generally adopted after the making the decision.

In case of merger and acquisition, valuation is the process which is carried out to estimate the exchange value for financial assets or liability by any of the following methods:

- Book value, replacement value, market value, present value, asset based valuation, relative valuation, dividend discount model, or by discounting factor model.

Though the significance of the methods of evaluation for merger and acquisitionis equally important as valuation methods, the less attention is given by the company.

Finally we canfinish our today's session with the object of spreading awareness of using such Evaluation Methods for Merger and Acquisition.

1)Trend Analysis of share prices –

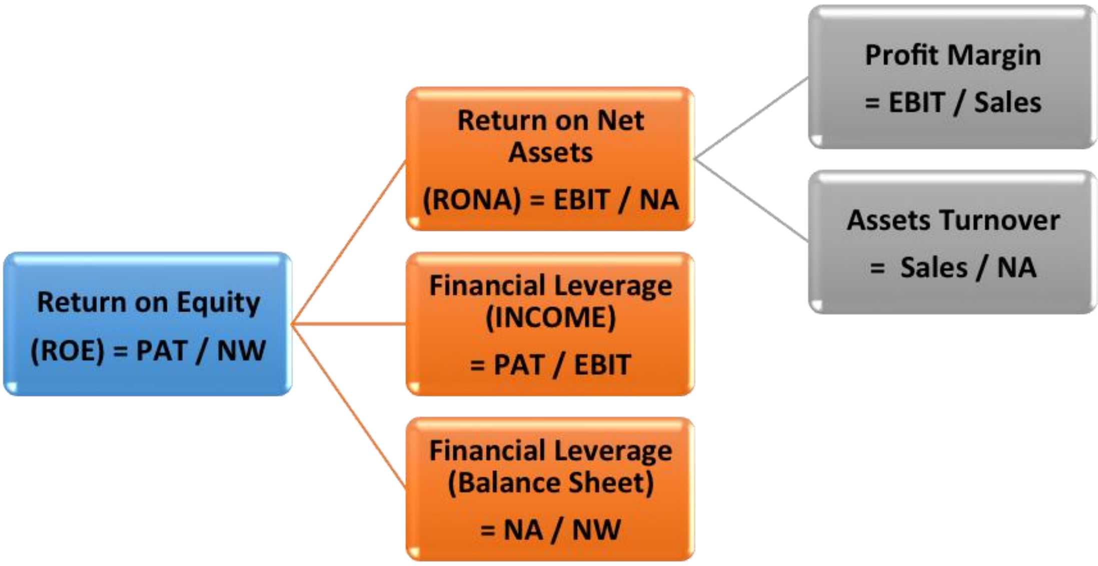
It is a simple financial evaluation in which acquirer company can examine the trends of share prices before the Merger and after the Merger and also can compares them to a reference group of corporations in similar industry to know the performance is improved or not. If company founds that the line of trend analysis chart goes upward after the Merger, it simply refers to have good Merger deal.

2)Ratio Analysis -

Ratio Analysis is most widely usedand a very well-knowntool for financial analysis. It is the relationship between two related items which is expressed in simple mathematical form. It isthe best indicator tool to measure the financial performance of a company. Acquirer company can analyse the merger deal by comparing the average ratio of pre-period with the average ratio of post period.

3) Du-Pont Analysis -

Du-Pont analysis is the precise form of ratio analysis where the list of pre-defined ratio is given and the pre-Merger and post-Merger averages for such a set of following key financial ratios were computed and compared with difference to evaluate the Merger deal.



4) Cost-Benefit Analysis–

The main object to evaluate the merger deal is to know the net economic advantage received by deducting cost of merger from benefit received bymerger.

To calculate cost benefit analysis following steps can be used:

i) **Cost =** Consideration paid to target company – Value worth of target company.

ii) **Benefit =** combined value worth of target company is more than separate value worth of both.

iii) When benefit is more than the cost it is consider as a great strategic Merger deal.

5) Statistical Analysis -

By t-Test

The pre-Merger and post-Merger averages for a set of key financial ratios were computed where the year in which merger deal occurs is denoted as base year. For the years prior to a merger, the performance of the acquiring firm alone are considered. For Post-merger years, the combined performance of firm is taken. The post-Merger performance was compared with the pre-Merger performance and tested for significant differences, using paired "t" test.

6. Summary

To summarised at the end, we can now understand the terminology, types valuation and also can evaluate any mergers or acquisitions deal from our discussion. From the objectives and advantages, we can also understand the increasing importance of mergers and acquisitions as a well-known expansion strategy of corporate restructuring.