Mergers Acquisitions and Corporate Restructuring – IAT -1

Part A

1. **A)Define Merger with examples**:
The simplest definition of merger is a " Combination of 2 or more business into one business. Any transaction that forms one economic unit from two / more previous ones.
It's a combination of two or more companies into a single company where one survive and other lose their corporate existence.
Ex: **Examples of mergers:**
Apple and Intel
Ford and Volvo
AT&T Inc buys Time Warner.
Rosneft Oil Company acquires Essar Oil.
Reliance Communications and Aircel.
Sony Pictures Network India acquired Zee Entertainment.
Unilever Plc acquired Blueair.
Nokia acquired Alcatel-Lucent.
Wipro acquired Health-Plan Services.

b) Synergy in merger:
Synergy: Concept
Synergy refers to a situation where the combined value of a firm is more than the sum of the values of individual firms.
It is a phenomenon where 2 +2 = 5
If the value of the firm A is VA, value of firm B is VB and Combined value of the firm is VAB
Value of the combined firm = Value of firm A + Value of firm B + Value of synergy
VAB = VA+ VB + VAB , is the value of synergy
or VAB = VAB – (VA+ VB)

c)Discuss various theories of merger:
Many theories have been advanced to explain why mergers and other forms of restructuring take place. Efficiency theories imply social gains from M&A activity in addition to the gains for participants.

1. Differential efficiency Theory
2. Inefficient Management Theory
3. Operating Synergy Theory:
4. Financial Synergy Theory:
5. Pure diversification Theory
6. Theory of Strategic Alignment:
7. Undervaluation Theory
8. Signaling Theory:

. **Differential efficiency theory:**
According to this theory, if the firm A acquires firm B, and if the management of firm A is more efficient than firm B, the efficiency of firm B is brought to the level of firm A.
This theory also implies that some firms operate below their potential and as a result have below average level of efficiency.
Such firms are more vulnerable to acquisitions by other most efficient firms in the same industry. This is because firms with greater efficiency would be able to identify firms with good potential but operating lower efficiency.

Inefficient Management theory:
This is similar to the concept of managerial efficiency but it is different, inefficient management means that the management of one company simply is not performing upto its potential
Inefficient management theory simply represents that is incompetent in the complete sense

Hubris motivation hypothesis:
Hubris hypothesis implies that managers look for acquisitions of firms for their own potential motive and that the economic gains are not only the motives for acquisitions
This theory is particularly evident in case of competitive tender offer to acquire a target. The urge to win the game often results in the winners curse refers to the ironic hypothesis that states that the firm which overestimates the value of the target mostly wins the context.

Operating Synergy Theory: The operating synergy theories postulates economies of scale or of scope and those mergers help achieve levels of activities at which they can be obtained. It includes the concept of complementary of capabilities.
For example, one firm might be strong in R&D but weak in marketing while another has a strong marketing department without the R&D capability. Merging the two firms would result in operating synergy

Financial Synergy Theory:
The financial synergy theory hypothesis complementarities between merging firms, not in management capabilities, but in the availability of investment opportunities an internal cash flow. A firm in a declining industry will produce large cash flows since there are few attractive investment opportunities.
A growth industry has more investment opportunities than cash with which to finance the. The merged firm will have a lower cost of capital due to the lower cost of internal funds as well as possible risk reduction, savings in flotation costs, and improvements in capital allocation.

Pure diversification Theory: Pure diversification as a theory of mergers differs from shareholder portfolio diversification. Shareholders can efficiently spread their investment and risk among industries, so there is no need for firms to diversify for the sake of their shareholders. Managers and other employees, however, are at greater risk if the single industry in which their firm operates should fail their firm specific human capital is not transferable.
Therefore, firms may diversify to encourage firm specific human capital investments which make their employees more valuable and productive, and to increase the probability that the organization and reputation capital of the firm will be preserved by transfer to another line of business owned by the firm in the event its initial industry declines

. **Theory of Strategic Alignment**: The theory of strategic alignment to changing environments says that mergers take place in response to environmental changes. External acquisitions of needed capabilities allow firms to adapt more quickly and with less risk than developing capabilities internally

Undervaluation Theory: The under valuation theory states that mergers occur when the market value of target firm stock for some reason does not reflect it true of potential value r its value I the hands of an alternative management. The q-ratio is also related to the under valuation theory. Firms can acquire assets for expansion more cheaply by buying the stock of existing firms than by buying or building the assets when the target's stock price is below the replacement cost of its assets.

Signaling Theory: Theories other than efficiency include information and signaling agency problems and managerialism, free cash flow, market power, taxes, and redistribution. The information or signaling theory attempts to explain why target shares seem to be permanently revalued upward in a tender offer whether or not it is successful. The information hypothesis says that the tender offer sends a signal to the market that the target shares are undervalued, or alternatively, the offer signals information to target management, which inspires them to implement a more efficient strategy on their own.

2a) **Difference merger and acquisition**

Distinction between mergers and acquisitions

Basis	Mergers	Acquisitions
1. Definition	Merger is considered to be a process when two or more companies come together to expand their business operations.	An acquisition occurs when one company or corporation takes control of another company and rules all its business operations
2. Terms	They are considered as amicable	They are considered as hostile
3. Stocks	New stocks are issued	No new stocks are issued
4. Companies	The companies of same size join hands together	The larger companies acquire smaller companies.

b) Influence of industry life cycle for restructuring activities:

Role of Industry Life Cycle Various Stages of Industry Life Cycle are

- Fragmentation Stage
- Shake Out Stage
- Maturity Stage &
- Decline Stage

1.**Fragmentation Stage**: At this stage,

the new industry normally arises when an entrepreneur overcomes the twin Problems of innovation and invention, a and works out how to being the new product and services into the market

Ex: **Example:** Air travel services of major airlines in Europe were sold to a target market at a high price, concentrating on people with high income group.

Ryan air was the first airline to engage low cost airlines in Europe. Its services were perceived as the innovation of the European Airline industry. Eliminated unnecessary services offered by traditional airlines. No free meals, uses paper-free air tickets, using secondary airports and offers frequent flights

2. **Shake out Stage**: During this stage, competitors start to realize business opportunities in the emerging industry. The value of the industry also rises.

Example: UK govt. decided to launch a campaign to encourage people to quit smoking. Nicorette, a manufacturer of various nicotine products encouraged people quit smoking by giving them Nicolette patches and Nicorette gums.

Nic Lite realized the opportunity and entered this industry and extended beyond UK border when the government introduced nonsmoking policy in public places. **This business threat created a new business opportunity to launch Nic Time** (an eight ounce bottle containing a lemon-flavored drink laced with nicotine, the same amount of nicotine as two cigarettes

3. **Maturity:** A stage at which the efficiencies of the dominant business model give these organization **competitive advantage over competition.** Some companies may shift some of the production to overseas for gaining competitive advantage.

Example – Toyota – export and import taxes mean that its cars lose competitiveness to the local competitors (in European market). Thus Toyota decided to open a factory at UK.

Nike has factories in China and Thailand as both countries have cheap labor and materials. However, their overseas partners are not allowed to sell shoes produced. These have to be shipped back to US, and then will be exported to other countries

4.Decline:

A stage during which a war **of slow destruction** between businesses may develop and those with heavy bureaucracies may fail. **In this stage, many companies may leave the industry** or they may develop new products / services. This will **create a new industry.**

Example : communication industry - the communication process of pagers couldn't be accomplished without telephones. To send messages to another pager, the user had to phone the call-center staff that would type and send

message to another pager. On the other hand, people who use mobile phones can make a phone-call and send messages to other mobiles without going thru call-center staff.

c) various types of mergers:

Types of merger

1. Horizontal Mergers
2. Vertical Mergers
3. Conglomerate Mergers
4. Concentric Mergers
5. Circular Combination

Horizontal Merger

This involves two firms operating in the **same kind of business** activity. Both acquiring and the target company belong to same industry.

Main purpose is :

To obtain economies of scale in production by eliminating duplication of facilities and operations.

This is a combination of two or more firms in **similar type of production, distribution or area of business.**

Vertical Merger

This occurs between firms in **different stages of activities like production or distribution combine with each other the combination is called as vertical merger.**

Ex: a Car company and company manufacturing a car component like piston (that is generally bought from others and used by the car manufacturing company).

Types of vertical mergers:

a) Forward integration
b) Backward integration

Forward integration: In this kind of vertical integration a combination of manufacturer with its customers.

Ex: When a TV manufacturer company combines with a TV marketing Company is an example of forward integration.

. Conglomerate Merger

This occurs between companies engaged into two **unrelated industries.**

Conglomerate merger represents a merger of firms engaged in unrelated lines of business.

Rationale for such merger: Diversification of risk

3 types of Conglomerate merger:

a) Product extension merger

b)**geographic market-extension merger**

c) **Pure conglomerate mergers**

Concentric Mergers:A congeneric merger is a type of merger where two companies are in the **same or related industries** or markets but do not offer the same products. In a congeneric merger, the

Companies may **share similar distribution channels**, providing synergies for the merger.

Therefore, if the activities of the segments brought together are so related that there is carryover of specific management functions (manufacturing finance, marketing, personnel, & so on) or complementarily in relative strengths among these specific management functions, the merger should be termed concentric rather than conglomerate

Circular Combination/circular merger

This happens among companies **producing distinct products** to **share common research and distribution facilities** to obtain economies by elimination of cost on duplication and promoting market enlargement.

Acquiring company has the benefit in form of economies of resource is sharing and diversification

When the firms belonging to the **different industries and producing altogether different products combine** together under the banner of central agency, it is referred as mixed or circular mergers.

Accretive merger:

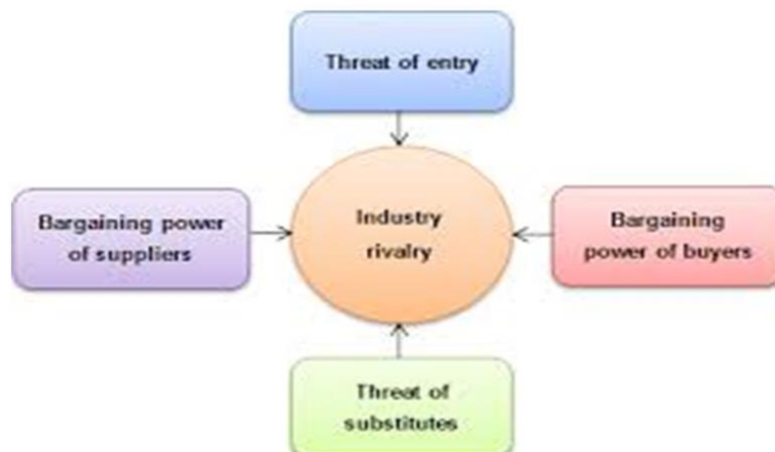
Acrretion is natural growth in size or extent by gradual external addition.
Accretion implies " Value Creation"
Accretive merger occurs when a company with high price to earning ratio (P/E) purchases a company with Low P/E. As a result, the EPS of the acquiring company increases.
Ex: HP announced a merger with servicing company EDS in 2008.

Dillutive merger:
The word dilutive implies " destruction or Dilution".
A dilutive merger is one where the EPS of the acquiring company falls after merger.
Since the EPS declines , the acquiring company's share price also declines, as the market expects a decrease in company earnings.
A dilutive merger or acquisition occurs when the P/E ratio of the acquiring firm is less than that of the target firm.

3a) List the reasons for failure of mergers:
A definite answer as to why mergers fail to generate value for acquiring shareholders cannot be provided because of a host of reasons for failure of mergers and Acquisitions. Some of the important reasons are given below:

a) Payment of Excessive Premium
b) Faulty Evaluation of Target Company
c) Mismatch between Acquirer and the Target
d) Lack of research
e) Failure to manage diversified business
f) Diverging from core activity
g) Failure to manage post merger integration

b)Porters 5 force model with respect to M & A
Competition:
The business strategy of an entity is determined to a great extent by the nature of competition prevailing in the industry. The degree and intensity of the competition in the industry determines the PROFIT POTENTIALITY of an entity. If the intensity of the competition is high, companies tend to spend heavily on the activities such as advertisements, and Price wars. The performance of an entity depends on the external forces.



Porters has identified 5 forces mode :

a) Bargaining power of suppliers
b) Threat of substitution
c) Bargaining power of buyers
d) Barriers to entry/ threat to new entrants

e) Internal rivalry and competition.

Of these, three forces constitute " Horizontal Competition" , namely:

a) Threat of substitute products
b) Threat of established rivals
c) The threat of new entrants

The other two forces constitute " Vertical Competition"

a) The bargaining power of suppliers

bThe bargaining power of buyers.

Bargaining power of supplier involves the following sub – elements:

a) Supplier concentration
b) Importance of Volume to supplier
c) Differentiation of inputs
d) Impact of inputs on cost differentiation
e) Switching costs of firms in the industry
f) Preference of substitute inputs
g) Threat of forward integration

Cost relative to total purchases in Industry.

2**.Threat of substitutes involving the following sub elements**:

a) Switching costs
b) Buyer inclination to substitutes
c) Price performance trade –offs of substitutes.

3. **Bargaining power of buyers involves the following sub elements**:

a) Bargaining leverage
b) Buyer volume
c) Buyer information
d) Brand identity
e) Price sensitivity
f) Threat of backward integration
g) Product differentiation
h) Buyer concentration Vs Industry
i) Availability of substitutes
j) Buyers incentives.

4**. Barriers to entry involves the following sub elements**:

a) Absolute cost advantage
b) Access to inputs
c) Switching costs
d)Government Policy
e)Economies of scale
f) Capital requirements
g) Brand identity
h)Access to distribution

5.**Degree of rivalry and Competition involves the following sub elements:**

a) Exit barriers
b) Industry concentration
c) Fixed costs/ Value added
d) Industry growth

Intermittent overcapacity
Product difference
Switching costs
Brand identity

Part B

4a) BCG Growth matrix

In the early 1970s, Bruce Henderson of the Boston Consulting Group developed a portfolio planning model and named it the BCG Matrix.

This model was based on the observations that a company's business units can be classified into **4 categories based on the combinations of market growth and market share relative to the large competitor.**

It was for this reason that the matrix was known as THE GROWTH – SHARE MATRIX.

This analysis indicates that **it is more attractive for an entity to have a high share in a high growth market than have markets that are slow growing, where the entity has a small share.**

When the market growth and market share are divided into two parts, one gets the 2 X2 matrix.

The cells of the matrix are used to classify the business of the diversified entity into categories such as:

a) STARS
b) CASH COWS
c) QUESTION MARKS
d) DOGS

STARS:

Stars are high growth companies, where the company holds a high market share.

Such a division or entity is likely to **generate adequate cash and always be self- sustaining.** Such divisions need to put a lot of effort in protecting their enviable positions and profit margins and increase turnover to derive cost- related economies.

An **acquirer should try to identify such divisions in the market**, **and if possible acquire them at all costs**. In case it already owns a division, the strategy to be adopted to attain further growth is to be aggressive- the entity should invest aggressively in R & D and expand its product portfolio.

Ex: when BMW bought Rover, experts through its products would help the German automaker reach new customers. However, the company was not able to capitalize on this opportunity, and it sold the Rover to a British firm and the Land Rover to Ford.

b) **Cash Cows**:

Cash Cows are the divisions that **hold a high share in mature** markets, **but do not have much growth potential left**.

On the account of the high market share, such divisions are able to generate adequate profits which can be used to fund divisions classified as STARS or QUESTION MARKS.

One should remember that companies often use the returns of one divisions to support other high potential business units.

If an entity own such a divisions, its strategy should be to defend and maintain their position in the market so that the division can be milked.

QUESTION MARKS

Such divisions represents one with a **low share, but a very high potential for growth as it is operating in fast-growing markets**. Such divisions need a lot of cash to exploit the growth opportunities available in the market. As such a generic strategy for such a division is that of high risk.

If the entity is able to generate cash through the cash cow divisions, the same could be invested aggressively in question marks.

If the entity is unable to generate cash, **this division should be divested,** as sustaining the division with its present low share is difficult.

DOGS:

These are businesses that have a very **small share in the market and have a very low growth potential**. They do not hold much future promise and are on the **verge of dying**.

Investing in such divisions **reflects a narrow view of the business, having no future except high risk**.

One need to remember that such divisions are cash traps and can eat only eat into the profits of the company

While looking for companies, the **acquirer should avoid such companies as they would not add any value but would result in increased losses and turn out to be a bad " buy decisions"**

Similarly if a company owns any such units or divisions, it is better to divest is as soon as possible, or else it would keep churning out loses and affect the overall profitability of the group.

In simple words, these divisions are like dogs that one should shoot- by liquidating and leaving the markets.

4b) Solution:

Value of firm A = VA = Rs 400 Lakhs

Value of firm B = VB= Rs 200 Lakhs

Value of combined firm VAB' =Rs 65 Lakhs

Cost involved for firm A =(Cash Paid- VB) = Rs 180 lakhs – Rs 200 Lakhs = Rs- 20 Lakhs

Synergy of firm VAB ' = Rs 65 Lakhs

Net gain = Value of synergy – Cost of merger

VAB' - Cost of merger

VAB ' – (cash Paid – VB)

VAB' = (VA + VB+ VAB)

Hence , net gains = VAB –(VA+VB) – Cost of synergy

665- (600) – (-20)

= 665 -600+20

= Rs 85 Lakhs.