INVESTMENT KNOWLEDGE SERIES

INTRODUCTION TO MERGERS & ACQUISITIONS

CAPITAL CITY & Training Consulting

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Introduction to Mergers & Acquisitions

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At various points in the manual a number of financial analysis issues are examined.
The financial analysis implications for these issues, although relatively standard in treatment, remain an opinion of the authors of this manual. No responsibility is assumed for any action taken or inaction as a result of the financial analysis included in the manual.

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1 • M&A Strategies

What is M&A?

The term ‘mergers and acquisitions’ refers to the buying and selling - acquiring and disposing - of both private businesses and public companies. In the case of the acquisition of a publicly traded company, this may also be referred to as a takeover.

In practice, very few transactions are structured as pure mergers, where two companies come together, combining their businesses and management teams, but with neither of them taking control of each other. The vast majority involve the acquisition of one company by another, with a clear target, acquirer (buyer) and vendor (seller).

Over many decades, M&A has been a major contributor to world economic growth, and in particular to activity in global financial markets.

The Goal of Acquisitions

The objective of an acquisition should be – and usually is – enhancement of shareholder value. At its simplest, this means that an acquirer has to be able to generate a better return on its capital than it would achieve otherwise. This could be achieved through increasing revenue, cutting costs, making its assets work more efficiently, solving problems with its suppliers or getting access to more opportunities for growth; or it could just come about through paying a low price for good assets.

In financial terms, enhancement of shareholder value requires that the net present value of the combined business (its post-acquisition cash flows, discounted by the post-acquisition cost of capital) must be greater than the sum of the pre-acquisition value of the acquirer and the acquisition cost.

A = acquirer; T = target

$$\text{Value }(A+T) > (\text{Value } A + \text{Cost } T)$$

Synergies

We need, at this stage, to introduce the concept of synergies. Synergies are benefits that can only come about when two entities are joined together; so that "two plus two equals five". To enhance shareholder value, the value of two businesses joined together must be greater than they were when they were separate. If the total future earnings from the acquisition, or total capital uplift, are less than or equal to the cost of the acquisition, then the deal is a wasted exercise. The benefits from the acquisition must outweigh the cost – and to achieve this, either the target must be 'cheap', or the acquisition must be able to generate synergies for the buyer.

Synergies are benefits that can only be achieved by putting two businesses together. They can be classified as follows:

- Commercial synergies: those benefits that come from improvements in the underlying business of the companies. For example, increased sales volumes; ability to charge higher prices; reduced production or administration costs; greater efficiencies. They will usually result in improved profit margins or better return on capital statistics.
- Financial synergies: those benefits that come from better use of capital. For example, being able to reduce the cost of borrowings or the cost of equity capital; reducing the company's tax charge; making use of surplus cash; improving the mix of equity and borrowings. Financial synergies are usually reflected in lower weighted average cost of capital (WACC) and improved earnings per share (EPS).
- Asset synergies: those benefits that come from better use of the acquirer's or target's assets. For example, combining administration functions and then selling the 'spare' head office building; using excess manufacturing capacity to generate higher production volumes; combining a distribution network. These synergies can be measured using metrics such as return on capital employed (ROCE) or return on assets (RoA).

Acquisition Strategies

Most acquisitions come about either because the acquirer's management has spotted an opportunity for growth, or because they have identified an issue which is restricting their growth. We could illustrate this using an example company – a UK chocolate manufacturer, called Bubbles.

Scale Acquisitions

Bubbles may be trying to increase its **market share**, in a competitive and shrinking market. It could do this by acquiring a regional competitor business, which would give it a larger share of its existing market while at the same time eliminating an element of competition. This type of transaction, aimed just at increasing the scale of operations, is sometimes referred to as a scale acquisition.

Where are the synergies? These could come from economies of scale: with this larger market share, Bubbles should have greater purchasing power, and be able to purchase raw materials more cheaply and perhaps extract a higher price from retailers. Asset synergies could also come from using the distribution networks of the target company more effectively, putting additional volumes through its production facilities and eliminating duplicated head office or other assets. In some cases the business could also achieve revenue synergies, if, by sharing brands or sales forces, the combined companies can create higher revenues than they could get independently.

Another area where value can be enhanced is management. This could come from applying management skills and expertise to problem-solve and re-energise the target, at the same time as eliminating any duplicated roles. And finally, by increasing the critical mass of the company, Bubbles may be able to achieve some financial synergies, through better and cheaper access to debt and equity capital or by pooling working capital resources.

Example

In July 2013, US hospital operator Tenet Healthcare Corp agreed to acquire its smaller competitor, Vanguard Health Systems for an equity value of $1.73 billion. According to Tenet's CEO Trevor Fetter "You have to have size and scale to succeed [in the current healthcare climate]". The transaction will make Tenet the second largest for-profit hospital operator in the US, leaving Community Health Systems Inc (which attempted a hostile takeover of Tenet in 2011) in third place. According to Mr Fetter, buying Vanguard will give Tenet more clout in negotiations with managed care providers, drug companies and medical device makers, while reducing overhead costs.

Scope Acquisitions

As an alternative to investing in its mainstream business, Bubbles could buy a company which also sells chocolate but in different geographical markets; or it could buy a business which sells different, complementary products (perhaps chocolate biscuits) in the same markets as the purchaser. This is sometimes referred to as a scope acquisition – a broadening of the scope of the acquirer – and also sometimes referred to as **horizontal integration**. Either way, Bubbles is staying within its central area of activity, but widening its geographical or product range.

Another form of scope acquisition is **vertical integration**. This is the term used when a company expands into different stages in its supply chain. For example, Bubbles might want to secure its access to good quality, competitively priced cocoa beans, and could do this by acquiring a cocoa plantation or harvesting business. Alternatively, if it wants to have control over its end markets, it might acquire a chocolate retail business. In this case, the synergies would come mainly from cost reduction – cutting out the margins paid to the middleman. However, the reduction in the company's risk will also contribute to an increase in its value.

Backward integration refers to an acquisition further back along the supply chain – for example, a manufacturer buying a producer of raw materials. Forward integration refers to an acquisition further on the supply chain – for example, a motor manufacturer buying a motor retailer or after-sales service business.

Example

In early 2013, retail giant Tesco announced the £48.6 million acquisition of the Giraffe restaurant chain. According to its press release, "the acquisition forms part of Tesco's strategy to develop the space in some of its larger stores and create even more compelling retail destinations where customers can meet, eat and drink, as well as shop. The first Giraffe restaurant to open next to a Tesco store will be near London".

Press comment suggested that the move was intended to try to revitalize sales, fighting back against a profit warning in 2012. It followed on from the acquisition of a coffee shop chain the year before.

Diversification

Diversification involves buying a company in an unrelated business. If Bubbles decided that there was limited growth in the chocolate market, it might acquire a company in a completely unrelated activity (say, clothing) or in a different but linked activity (such as bakery products). The scope for synergies is far lower with this strategy; in most cases it relies on financial and asset synergies to enhance shareholder value. This is a strategy which was popular in Europe and North America in the 1980s but fell out of favour in the 1990s, as investors developed a preference for focused businesses.

There are some notable exceptions: Berkshire Hathaway, for example, has a very successful model of growth by focused, diversified acquisition. The diversified conglomerate corporate model is also strong in much of the Far East. One example is Samsung of Korea, which owns businesses as wide-ranging as consumer electronics, military hardware, apartments, ships and an amusement park.

Example

Hanson Trust was founded in the 1960s with a strategy of buying undervalued businesses and turning them round; by the 1990s the group had bought into clothing, building materials and chemicals as well as acquiring the high-profile Imperial Tobacco Group and Consolidated Goldfields. By the mid 1990s diversification was out of favour with the market, and Hanson split itself into four, separately-focused businesses.

Other Reasons for Acquisitions

Capital efficiency might be a motive for Bubbles to make acquisitions. Since the credit crisis, companies have accumulated cash to a point where, according to credit rating agency Moody's, US non-financial corporates had total cash balances of $1.24 trillion by the end of 2011; Apple, for example, had over $121 billion in cash by the end of 2012.

A trading company with significant amounts of surplus cash is likely to find its share price depressed, because this cash is an asset that earns a pitiful return, and dilutes both the company's earnings per share and its return on capital employed. If there is no short-term use for the cash in the business, Bubbles would eventually find itself under pressure from its shareholders to release the cash, either by making acquisitions, or through a return to shareholders in the form of special dividends or share buybacks.

Example

Predator has €100 million net assets, of which €20 million is surplus cash on deposit. The remaining €80 million generates a return of 8%, in line with the sector average. The post-tax interest receivable on cash is 1.5%.

€80 million x 8% = €6.4 million

€20 million x 1.5% = €0.3 million

€6.7 million

Predator's return on equity is: $\dfrac{\text{€6.7 million}}{\text{€100 million}}$ = 6.7%: well below the sector level of 8%.

Unusually, a company may be required to buy another for **regulatory reasons**. Under the UK Takeover Code, for example, when a person or persons acting in concert acquire a holding which gives them 30% or more of the voting rights in a public company, they are required to make a mandatory offer for that company; i.e., an offer to acquire all the remaining shares of that company.

Example

In 2011, Hong Kong based investment company Guoco held 29.2% of the voting rights in London-listed Rank, operator of Mecca bingo halls. In May 2011, Guoco bought a further 11.6% of Rank's shares, taking its stake to 40.8%. This triggered a mandatory bid whereby Guoco had to make an offer to acquire all of the shares they did not hold. The offer had to include a cash option and be priced above a regulatory minimum threshold.

A whole range of **other reasons** may lie behind acquisitions. Fear of takeover may prompt public companies to make pre-emptive acquisitions. This could be to 'get in first' with an attack on a potential bidder, to make themselves appear more dynamic, or to make themselves too big to be acquired themselves. Other purchasers (like Hanson, above) might specialize in asset-stripping – buying underperforming, failing or illiquid companies at a discount, in order to sell off under-valued assets at a higher price. And of course there may be personal elements, such as management ambition, greed, or inter-company feuds, that drive a board towards an acquisition strategy.

Disposal Strategies

An active M&A market needs both willing, funded buyers and willing, realistic sellers, with a common view on pricing. So, looking now at the other side of the transaction, why are businesses sold?

Strategic Disposals

A corporate strategic review may prompt a company to refocus its activities in a particular direction, or to focus only on those activities it considers to be core, so that the board adopts a disposal strategy. There are many reasons that specific companies are selected:

- Sometimes the businesses to be sold are under-performing, relative to the group, and therefore dilute shareholder returns and EPS.
- There may be a lack of synergies between the subsidiaries and the group, so that there is no visible logic in keeping them. The capital invested in them can be used more profitably elsewhere.
- The parent may have acquired a company with non-core or unwanted subsidiaries, and choose to sell these off to recover some of the acquisition cost and create a more streamlined whole.

Cash can of course be a key disposal driver; if a parent company is short of cash and has limited or no access to credit facilities or equity funding, it may have to resort to asset sales, including business disposals, to create liquidity. Sometimes there is one particular subsidiary that is highly cash negative, or needs substantial cash to expand, so that the decision is taken to spin it off.

In owner-managed businesses, the disposal may be motivated by **personal considerations** such as the retirement of the owner-manager (with the timing often dictated by tax planning issues) combined with lack of family succession. Other personal motivations could include financial necessity, perhaps due to litigation or divorce, or even boredom.

Private equity and venture capital firms are always, by their nature, both buyers and sellers. The classic management buy-out (MBO) model starts with the private equity firm's co-acquisition of a business, alongside incumbent management, from its previous owners. This is followed by financial and management investment in that business, in order to create a step change in its equity value. Then, after around three to five years, comes the exit – with the private equity firm either selling that business, or carrying out an IPO, in order to realize a capital gain and release funds for further reinvestment in other businesses.

This three- to five-year cycle of 'find-buy-change-sell' means that private equity firms have been major players in the M&A markets, both as acquirers and sellers, for decades.

Occasionally a disposal is required for **regulatory reasons**. One example is where an anti-trust (competition) ruling requires an acquirer to sell all or part of its acquisition target, to avoid a monopolistic or anti-competitive situation. Equally, a purchaser or vendor could agree to dispose of a subsidiary during the course of negotiations, in a pre-emptive attempt to avoid a negative ruling. Sometimes, regulatory changes within a specific industry may give rise to a wave of disposals; for example, the privatization of the electricity industry in the UK in the 1990s involved the break up of companies into transmission, supply, retail and generation.

Example

In January 2013, the UK Office of Fair Trading investigated Vue Entertainment's proposed acquisition of Apollo Cinemas, and concluded that there were concerns over competition in four regions. Vue undertook to sell the four local cinemas concerned, and as a result the Vue/Apollo transaction was approved.

From Strategy to Success

It is a very long way from formulating a strategy to enhancing shareholder value. In the following chapters, we will examine the processes for private company acquisitions and disposals, the process of public takeover. We will then move on to see how deal structuring can affect the outcome of a transaction, before concluding with a discussion on post-acquisition integration.

2 • Acquiring Private Companies

Private Company Acquisitions: A Process Overview

An overview of the acquisition process is shown in the following diagram.

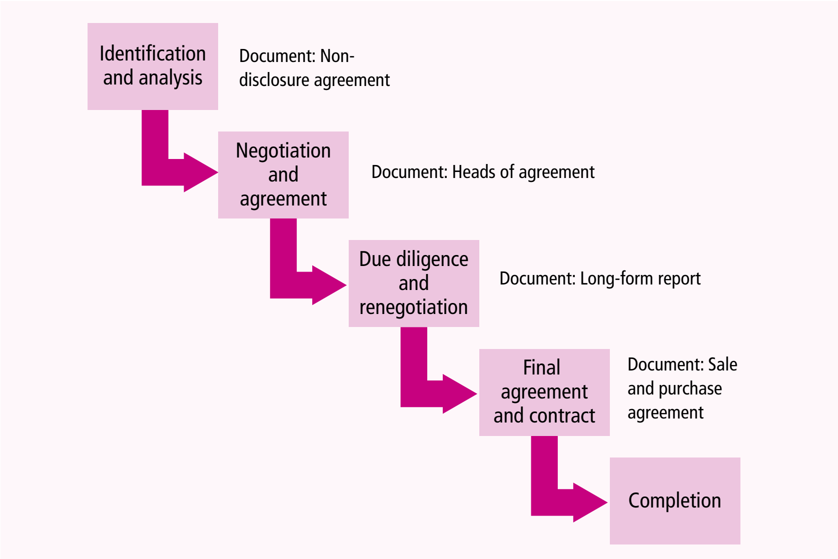

Figure 1: M&A Process overview

Early Stages

The start of any acquisition process is the identification and analysis of targets. It is critical at this early stage to understand the deal motivation, and set clear acquisition criteria.

The first question for management is: Why are we looking for acquisitions? Is this to acquire access to a particular market; to reduce exposure to a particular customer or market; to improve a competitive position? Whatever the rationale it must be clearly agreed, expressed and communicated to the deal team, including financial and legal advisers.

Following on from this, the acquirer should set clear criteria for suitable targets, being as specific as possible. Most acquirers will have a clear understanding of the minimum size of business they need and the maximum possible purchase consideration; but there are many other factors to consider; for example, are they looking for businesses with strong incumbent management, or are they happy with retirement situations? Is there a requirement for specific technology, location, market focus, profitability levels?

Identifying targets may be done in-house, if the acquirer has enough resource, or it can be done by its advisors. Larger companies will often be approached by the origination teams of investment banks, with proactively identified potential deal opportunities. The identification will involve researching potential targets from a range of sources including databases and their own industry knowledge and contacts. At this early stage, there is only limited information available in the public domain about private company targets, such as annual filings, news reports and market surveys, and this should be used for initial analysis and short-listing.

The approach to potential targets may be done either by advisors or by the acquirer, depending on the level of confidentiality required. Any approach should be made at an appropriate level. If the target is part of a group, the approach should be made to the CEO of the parent company; if it is private equity backed, then the approach should be made to the private equity firm; and for an owner-managed business the approach should be made to the owner.

Target Analysis and Evaluation

If the approach meets with a positive response, then the next stage is generally to meet, request additional information and sign a NDA (non-disclosure agreement, also called a confidentiality undertaking).

The NDA is a legally binding agreement, in this case signed by the potential acquirer, confirming that any non-public information provided in relation to the target will be safeguarded, not disclosed to any other party, and not used for any purpose other than that of considering the potential purchase of the target.

What information should the acquirer seek at this stage? It varies of course from company to company, but a sample request list would include:

- Latest financial statements
- Management accounts for the year to date, with commentary
- Current year budgets and longer-term forecasts

This recent addition to Capital's Investment Knowledge Series is an essential introduction to the complex world of M&A and will be invaluable for anyone looking to expand their business, or moving into a career in corporate finance. It provides a clear and concise, jargon-busting explanation of key concepts and processes, illustrated with real-life examples throughout.

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