

# Mergers and acquisitions

Topic Gateway Series No. 54



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# Mergers and acquisitions

## Definition and concept

The terms 'merger' and 'acquisition' are often used interchangeably, although they have slightly different meanings:

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. Both companies' stocks are surrendered and new company stock is issued in its place.'

*Investopedia, 2008*

An acquisition happens:

'... when one company takes over another and clearly establishes itself as the new owner, the purchase is called an acquisition. From a legal point of view, the target company (i.e. the acquired company) ceases to exist, the buyer 'swallows' the business and the buyer's stock continues to be traded.'

*Investopedia, 2008*

Mergers are much less common than acquisitions. However, both parties will often describe a deal as a merger, even if it is technically an acquisition. This is done to placate the target company's management, staff and shareholders, who may have a negative perception of being taken over by another company.

In practice, whether a deal is considered a merger or acquisition usually depends on how the deal is communicated publicly. It also depends on how the target company's shareholders, management and employees perceive it.

## Related concepts

Capital structuring; competition; corporate finance; demerger; divestiture; management buy-ins (MBIs); management buy-outs (MBOs); valuation; vertical integration.

## Alternative concepts

Company turnaround; cost reduction; joint ventures; restructuring; strategic alliances.

## Context

Mergers and acquisitions (M&A) are a key strategy for business growth in today's highly competitive, global economy. Knowledge of M&A strategies and processes is relevant to management accountants at all levels. CIMA students will find this subject of particular relevance to Paper P6 – Business Strategy and TOPCIMA.

## Overview

Driven by globalisation and strategic or economic barriers to internal growth, mergers and acquisitions (M&As) are one of the principal ways in which organisations can achieve rapid growth.

In the past, M&As were focused primarily on gaining control of undervalued assets which could then be either broken-up and traded (known as 'asset-stripping') or developed as autonomous units. Today, the typical M&A is more strategic or operational in its intent, with an emphasis on achieving industry consolidation or access to new markets.

Common reasons for M&A deals:

- access to a developed customer base and cash flow (including new distribution channels or geographic markets)
- access to new technologies and organisational capabilities that can be leveraged to extend strategic opportunities
- consolidation of business units or industries to increase revenue and share prices
- ability to leverage economies of scale and synergies that reduce the costs of the combined company, relative to total revenues.

However, according to a 2007 study of over 200 major European M&As by consultancy Hay Group, nine out of ten corporate M&As fall short of their objectives. For British companies, the success rate was even lower, with just 3% percent of senior business leaders saying that they were 'completely successful' in achieving their stated objectives.

The research found the primary causes of M&A failure to be:

- a preoccupation by business leaders on finance and systems issues at the expense of the vital, intangible assets critical to a merger process. These include human resources, business culture, company structure and corporate governance

- poor due diligence which failed to obtain intelligence on the corporate culture and human capital of M&A target companies
- weak post-merger integration strategies that put little emphasis on integrating senior management and the workforce

However, there are also many examples of successful deals, including Tyco, Cisco, Philip Morris and Johnson & Johnson, where additional shareholder value has been created. The determinants for success are:

- the deal must create value in a way that the target or acquirer cannot achieve independently. This can be in terms of operating, financial or tax benefits. In other words, synergy must be created and maintained by the buyer
- the purchase premium must not exceed the value of the synergies resulting from the combination
- the acquirer must outperform the expectations that are already reflected in the target company's share price.

## Application

The acquisition or merger of businesses is a complex process which typically involves the following steps:

1. **Strategic Planning** – this is usually developed at two levels.
  - Corporate – understanding the company's competitive advantage and its applications, for example, technology and marketing; evaluating options for achieving the company's strategic objectives, including, organic growth, joint venture or an M&A; developing a tactical plan to achieve the company's vision.
  - Business Unit – developing the unit's strategy for line extensions, pricing, new products and entry into new related markets.

At the corporate level, acquisitions may play a primary role, in diversification and growth. At the business unit level, acquisitions are likely to play a supporting role.

Companies need to determine their strategic objectives at the beginning of the process, as they form the foundation for all that follows.

Once a company has decided to pursue an M&A strategy, it should develop criteria to define what kind of target company will help them to meet their strategic goals. The company should also devise a strategy to determine the terms on which a deal might be made, for example, part cash/part stock, external funding from banks and/or other investors. It should evaluate what financial and non-financial resources are needed to complete the deal.

2. Evaluation – At this point, the company needs to identify potential targets. Often this will involve using external agents who are specialised in researching opportunities.

Given the vast array of information available, it is essential to have clear acquisition criteria in order to prevent wasting significant amounts of time and money.

As potential targets are identified, a number of 'screens' are applied to ensure that target companies will meet the acquirer's strategic objectives.

Step	Activity
1	Develop a list of companies
2	Size screen (i.e. revenues)
3	Profitability screen (i.e. margins)
4	Customer screen
5	Distribution channel screen
6	Manufacturing/delivery screen
7	Technology screen
8	Corporate culture screen
9	Investigation of remaining targets
10	Recommended shortlist

Likely information sources on potential targets include:

- company annual reports
- analyst reports
- investment banker networks
- internet
- internal expertise.

3. Initial Contact – At this point, companies need to determine the most appropriate means of contacting the target company. Executives from the acquiring company may contact the identified priority targets directly or through an agent.

At some point during this phase, senior managers of both parties will need to meet and develop the basis for a working relationship. This will include:

- confidentiality agreements
- preliminary disclosure information (help to ascertain strategic fit, business performance and potential synergies)
- memorandum (timetable, rules of engagement, bid procedure)
- financial results and projections
- initial indication of interest (non-binding bid, initial due diligence, availability of funds, conditions to closing).

It is important that the M&A project leadership are sufficiently empowered to act on the company's behalf throughout the deal stages of the M&A to ensure a successful progress.

4. Valuation – The acquiring company will need to gather sufficient financial and market information to make a valuation of the target company.

There are a number of approaches for valuing a company:

Asset valuation. This is based on the balance sheet value of the firm's capital assets.

Historical earnings valuation. This is the most commonly used of all valuation methods. It typically takes financial data from the company's previous three years and assumes the business will generate at least as much cash in future.

Future earnings valuation. This method uses projections of expected future cash flows and values the company using discounted cash flow (DCF) techniques. DCF values a business by discounting projected cash flow available to both debt and equity holders over the life of the business. The present value of cash flows is then adjusted for cash, debt and redundant assets to arrive at an indication of equity value.

Relative valuation. This approach uses comparable companies in terms of industry, size, capital structure or growth rates where a market value can be obtained to establish a value for the target company.

5. Due Diligence – The acquiring business will then need to perform an in-depth investigation and analysis of every aspect of a company, its management and its operations.

There are three stages of due diligence:

- a. Preliminary (public data)
- b. Primary (data room)
- c. Pre-closing (external audit).

The primary objectives of due diligence includes:

- identifying potential deal breakers
  - obtaining information for the valuation
  - gathering information that could be useful for the negotiation team
  - identifying areas that need immediate management attention post-acquisition
  - identifying synergies and possible costs
  - developing a basis for post-merger integration plans
  - verifying the sellers' representations.
6. Deal Execution – The next stage is the negotiation of the deal. Negotiation of a definitive agreement can be time consuming. The acquiring business will need to bring together a mix of experiences and backgrounds into the deal team, including:
    - business representation
    - M&A expertise
    - legal
    - functional support, such as tax, treasury, accounting, environmental and risk management.

When a definitive agreement has been negotiated to the satisfaction of the buyer and seller, a formal 'closing' is normally held. A number of pre-closing activities will need to be performed:

- communication plan – internal, local community, investors
  - antitrust and/or government filings
  - interim management of operations
  - pre-closing due diligence
  - transfer of funds.
7. Integration – After closing is complete, the acquiring company must then start the process of assimilating the acquired company into their business. The level of integration varies according to the overlap with the acquired business.

Typically, the goals of integration are to:

- integrate the business quickly into one organisation which is the right size for the future
- integrate and retain the best people from both organisations into one high performing team
- build support for the new organisation with employees, customers and suppliers
- achieve valuation commitments.

Most acquiring businesses will prepare a 100 day plan to cover the initial period of integration. The purpose of the plan is to:

- identify key events and activities that should take place in the first 100 days to achieve the above integration goals
- identify the required resources to integrate the new businesses
- develop a plan for each functional area including sales, marketing, finance, IT, HR and operations
- ensure open communication
- drive synergy realisation
- achieve transition from integration to business team.

8. Post-deal evaluation – The final stage of any merger or acquisition is the post-deal evaluation. At this stage, the objective is to ascertain whether the expected results of the M&A have materialised.

Often it is difficult to identify the incremental revenues and costs that have resulted from the deal. This is usually because of the inability of accounting systems to capture and identify these items separately. Meanwhile, the acquisition team would rarely have had the time or resources to put sophisticated measurement processes in place before signing the deal.

In reality, many post-deal financial evaluations are often measured in an unsophisticated way, based on high-level assumptions and allocations. Often the same people who were involved in justifying the deal are later asked to report on its success. This leads to the possibility that some elements of the post-deal analysis are ignored or under-played.

Finance managers have a key role to play throughout the M&A process and are usually integral to the M&A deal team. Their role will often include:

- providing project leadership and co-ordinating key resources required to support the deal, for example, accounting firms, tax specialists, financial advisers and regulators
- analysing pro-forma financial statements of the target company, and understanding the tax and accounting effects of any deal, and the M&A costs
- valuing the M&A deal and developing the business case
- supporting the deal negotiation and preparing and commenting on key documents
- integrating financial teams, systems and processes of the newly acquired or merged business
- providing post-deal evaluation analysis.

As noted in the 2007 Hay Group study, successful M&A deals rely on robust due diligence which covers all aspects of a target company's business – financial, structural, cultural and human capital. They also depend on strong post-merger integration strategies that emphasise the importance of integrating senior management and the workforce into the new organisation.

## Case studies

The Close Brothers website has a number of case studies on recent client M&A transactions across a range of different industry sectors.

Available from: <http://digbig.com/4xsxs>

[Accessed 30 October 2008]

Global M&A has a case study library with more than 15 examples of recent client M&A transactions. Available from: <http://digbig.com/4xsxt>

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The Goliath website provides access to a case study on the recent acquisition of Ben & Jerry's by Unilever. This gives an interesting perspective on the issues of cultural integration of acquisitions. Available from: <http://digbig.com/4xsxw>

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*Mergers and acquisitions involving UK companies* provides a freely available quarterly update containing data on domestic and overseas acquisitions and mergers. Available from: <http://digbig.com/4xtbc>

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