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The Basics Of Mergers And Acquisitions

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Introduction

Mergers and acquisitions (M&A) and corporate restructuring are a big part of the corporate finance world. Every day, Wall Street investment bankers arrange M&A transactions, which bring separate companies together to form larger ones. When they're not creating big companies from smaller ones, corporate finance deals do the reverse and break up companies through spinoffs, carve-outs or tracking stocks.

Not surprisingly, these actions often make the news. Deals can be worth hundreds of millions, or even billions, of dollars. They can dictate the fortunes of the companies involved for years to come. For a CEO, leading an M&A can represent the highlight of a whole career. And it is no wonder we hear about so many of these transactions; they happen all the time. Next time you flip open the newspaper's business section, odds are good that at least one headline will announce some kind of M&A transaction.

Sure, M&A deals grab headlines, but what does this all mean to investors? To answer this question, this tutorial discusses the forces that drive companies to buy or merge with others, or to split-off or sell parts of their own businesses. Once you know the different ways in which these deals are executed, you'll have a better idea of whether you should cheer or weep when a company you own buys another company - or is bought by one. You will also be aware of the tax consequences for companies and for investors

Defining M&A

The Main Idea

One plus one makes three: this equation is the special alchemy of a merger or an acquisition. The key principle behind buying a company is to create shareholder value over and above that of the sum of the two companies. Two companies together are more valuable than two separate companies - at least, that's the reasoning behind M&A.

This rationale is particularly alluring to companies when times are tough. Strong companies will act to buy other companies to create a more competitive, cost-efficient company. The companies will come together hoping to gain a greater market share or to achieve greater efficiency. Because of these potential benefits, target companies will often agree to be purchased when they know they cannot survive alone.

Distinction between Mergers and Acquisitions

Although they are often uttered in the same breath and used as though they were synonymous, the terms merger and acquisition mean slightly different things.

When one company takes over another and clearly established itself as the new owner, the purchase is called an acquisition. From a legal point of view, the target company ceases to exist, the buyer "swallows" the business and the buyer's stock continues to be traded.

In the pure sense of the term, 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. This kind of action is more precisely referred to as a "merger of equals." Both companies' stocks are surrendered and new company stock is issued in its place. For example, both Daimler-Benz and Chrysler ceased to exist when the two firms merged, and a new company, DaimlerChrysler, was created.

In practice, however, actual mergers of equals don't happen very often. Usually, one company will buy another and, as part of the deal's terms, simply allow the acquired firm to proclaim that the action is a merger of equals, even if it's technically an acquisition. Being bought out often carries negative connotations, therefore, by describing the deal as a merger, deal makers and top managers try to make the takeover more palatable.

A purchase deal will also be called a merger when both CEOs agree that joining together is in the best interest of both of their companies. But when the deal is unfriendly - that is, when the target company does not want to be purchased - it is always regarded as an acquisition.

Whether a purchase is considered a merger or an acquisition really depends on whether the purchase is friendly or hostile and how it is announced. In other words, the real difference lies in how the purchase is communicated to and received by the target company's board of directors, employees and shareholders.

Synergy

Synergy is the magic force that allows for enhanced cost efficiencies of the new business. Synergy takes the form of revenue enhancement and cost savings. By merging, the companies hope to benefit from the following:

- Staff reductions - As every employee knows, mergers tend to mean job losses. Consider all the money saved from reducing the number of staff members from accounting, marketing and other departments. Job cuts will also include the former CEO, who typically leaves with a compensation package.
- Economies of scale - Yes, size matters. Whether it's purchasing stationery or a new corporate IT system, a bigger company placing the orders can save more on costs. Mergers also translate into improved purchasing power to buy equipment or office supplies - when placing larger orders, companies have a greater ability to negotiate prices with their suppliers.
- Acquiring new technology - To stay competitive, companies need to stay on top of technological developments and their business applications. By buying a smaller company with unique technologies, a large company can maintain or develop a competitive edge.
- Improved market reach and industry visibility - Companies buy companies to reach new markets and grow revenues and earnings. A merge may expand two companies' marketing and distribution, giving them new sales opportunities. A merger can also improve a company's standing in the investment community: bigger firms often have an easier time raising capital than smaller ones.

That said, achieving synergy is easier said than done - it is not automatically realized once two companies merge. Sure, there ought to be economies of scale when two businesses are combined, but sometimes a merger does just the opposite. In many cases, one and one add up to less than two.

Sadly, synergy opportunities may exist only in the minds of the corporate leaders and the deal makers. Where there is no value to be created, the CEO and investment bankers - who have much to gain from a successful M&A deal - will try to create an image of enhanced value. The market, however, eventually sees through this and penalizes the company by assigning it a discounted share price. We'll talk more about why M&A may fail in a later section of this tutorial.

Varieties of Mergers

From the perspective of business structures, there is a whole host of different mergers. Here are a few types, distinguished by the relationship between the two companies that are merging:

- Horizontal merger - Two companies that are in direct competition and share the same product lines and markets.
- Vertical merger - A customer and company or a supplier and company. Think of a cone supplier merging with an ice cream maker.
- Market-extension merger **-** Two companies that sell the same products in different markets.
- Product-extension merger **-** Two companies selling different but related products in the same market.
- Conglomeration - Two companies that have no common business areas.

  There are two types of mergers that are distinguished by how the merger is financed. Each has certain implications for the companies involved and for investors:
  - Purchase Mergers - As the name suggests, this kind of merger occurs when one company purchases another. The purchase is made with cash or through the issue of some kind of debt instrument; the sale is taxable.

    Acquiring companies often prefer this type of merger because it can provide them with a tax benefit. Acquired assets can be written-up to the actual purchase price, and the difference between the book value and the purchase price of the assets can depreciate annually, reducing taxes payable by the acquiring company. We will discuss this further in part four of this tutorial.
  - Consolidation Mergers - With this merger, a brand new company is formed and both companies are bought and combined under the new entity. The tax terms are the same as those of a purchase merger.

Acquisitions

As you can see, an acquisition may be only slightly different from a merger. In fact, it may be different in name only. Like mergers, acquisitions are actions through which companies seek economies of scale, efficiencies and enhanced market visibility. Unlike all mergers, all acquisitions involve one firm purchasing another - there is no exchange of stock or consolidation as a new company. Acquisitions are often congenial, and all parties feel satisfied with the deal. Other times, acquisitions are more hostile.

In an acquisition, as in some of the merger deals we discuss above, a company can buy another company with cash, stock or a combination of the two. Another possibility, which is common in smaller deals, is for one company to acquire all the assets of another company. Company X buys all of Company Y's assets for cash, which means that Company Y will have only cash (and debt, if they had debt before). Of course, Company Y becomes merely a shell and will eventually liquidate or enter another area of business.

Another type of acquisition is a reverse merger, a deal that enables a private company to get publicly-listed in a relatively short time period. A reverse merger occurs when a private company that has strong prospects and is eager to raise financing buys a publicly-listed shell company, usually one with no business and limited assets. The private company reverse merges into the public company, and together they become an entirely new public corporation with tradable shares.

Regardless of their category or structure, all mergers and acquisitions have one common goal: they are all meant to create synergy that makes the value of the combined companies greater than the sum of the two parts. The success of a merger or acquisition depends on whether this synergy is achieved.

Valuation Matters

Investors in a company that is aiming to take over another one must determine whether the purchase will be beneficial to them. In order to do so, they must ask themselves how much the company being acquired is really worth.

Naturally, both sides of an M&A deal will have different ideas about the worth of a target company: its seller will tend to value the company at as high of a price as possible, while the buyer will try to get the lowest price that he can.
There are, however, many legitimate ways to value companies. The most common method is to look at comparable companies in an industry, but deal makers employ a variety of other methods and tools when assessing a target company. Here are just a few of them:

1. Comparative Ratios - The following are two examples of the many comparative metrics on which acquiring companies may base their offers:

- Price-Earnings Ratio (P/E Ratio) - With the use of this ratio, an acquiring company makes an offer that is a multiple of the earnings of the target company. Looking at the P/E for all the stocks within the same industry group will give the acquiring company good guidance for what the target's P/E multiple should be.
- Enterprise-Value-to-Sales Ratio (EV/Sales) - With this ratio, the acquiring company makes an offer as a multiple of the revenues, again, while being aware of the price-to-sales ratio of other companies in the industry.

2. Replacement Cost - In a few cases, acquisitions are based on the cost of replacing the target company. For simplicity's sake, suppose the value of a company is simply the sum of all its equipment and staffing costs. The acquiring company can literally order the target to sell at that price, or it will create a competitor for the same cost. Naturally, it takes a long time to assemble good management, acquire property and get the right equipment. This method of establishing a price certainly wouldn't make much sense in a service industry where the key assets - people and ideas - are hard to value and develop.

3. Discounted Cash Flow (DCF) **-** A key valuation tool in M&A, discounted cash flow analysis determines a company's current value according to its estimated future cash flows. Forecasted free cash flows (operating profit + depreciation + amortization of goodwill – capital expenditures – cash taxes - change in working capital) are discounted to a present value using the company's weighted average costs of capital (WACC). Admittedly, DCF is tricky to get right, but few tools can rival this valuation method.

Synergy: The Premium for Potential Success

For the most part, acquiring companies nearly always pay a substantial premium on the stock market value of the companies they buy. The justification for doing so nearly always boils down to the notion of synergy; a merger benefits shareholders when a company's post-merger share price increases by the value of potential synergy.

Let's face it, it would be highly unlikely for rational owners to sell if they would benefit more by not selling. That means buyers will need to pay a premium if they hope to acquire the company, regardless of what pre-merger valuation tells them. For sellers, that premium represents their company's future prospects. For buyers, the premium represents part of the post-merger synergy they expect can be achieved. The following equation offers a good way to think about synergy and how to determine whether a deal makes sense. The equation solves for the minimum required synergy:

$$\frac{\text{Pre}-\text{Merger Value of Both Firms}+\text{Synergy}}{\text{Post}-\text{Merger Number of Shares}}=\text{Pre}-\text{Merger Stock Price}$$

In other words, the success of a merger is measured by whether the value of the buyer is enhanced by the action. However, the practical constraints of mergers, which we discuss in part five, often prevent the expected benefits from being fully achieved. Alas, the synergy promised by deal makers might just fall short.

What to Look For
It's hard for investors to know when a deal is worthwhile. The burden of proof should fall on the acquiring company. To find mergers that have a chance of success, investors should start by looking for some of these simple criteria:

- A reasonable purchase price - A premium of, say, 10% above the market price seems within the bounds of level-headedness. A premium of 50%, on the other hand, requires synergy of stellar proportions for the deal to make sense. Stay away from companies that participate in such contests.
- Cash transactions - Companies that pay in cash tend to be more careful when calculating bids and valuations come closer to target. When stock is used as the currency for acquisition, discipline can go by the wayside.
- Sensible appetite – An acquiring company should be targeting a company that is smaller and in businesses that the acquiring company knows intimately. Synergy is hard to create from companies in disparate business areas. Sadly, companies have a bad habit of biting off more than they can chew in mergers.

Mergers are awfully hard to get right, so investors should look for acquiring companies with a healthy grasp of reality.

Doing The Deal

Start with an Offer
When the CEO and top managers of a company decide that they want to do a merger or acquisition, they start with a tender offer. The process typically begins with the acquiring company carefully and discreetly buying up shares in the target company, or building a position. Once the acquiring company starts to purchase shares in the open market, it is restricted to buying 5% of the total outstanding shares before it must file with the SEC. In the filing, the company must formally declare how many shares it owns and whether it intends to buy the company or keep the shares purely as an investment.

Working with financial advisors and investment bankers, the acquiring company will arrive at an overall price that it's willing to pay for its target in cash, shares or both. The tender offer is then frequently advertised in the business press, stating the offer price and the deadline by which the shareholders in the target company must accept (or reject) it.

The Target's Response

Once the tender offer has been made, the target company can do one of several things:

- **Accept the Terms of the Offer** - If the target firm's top managers and shareholders are happy with the terms of the transaction, they will go ahead with the deal.

- **Attempt to Negotiate** - The tender offer price may not be high enough for the target company's shareholders to accept, or the specific terms of the deal may not be attractive. In a merger, there may be much at stake for the management of the target - their jobs, in particular. If they're not satisfied with the terms laid out in the tender offer, the target's management may try to work out more agreeable terms that let them keep their jobs or, even better, send them off with a nice, big compensation package.

  Not surprisingly, highly sought-after target companies that are the object of several bidders will have greater latitude for negotiation. Furthermore, managers have more negotiating power if they can show that they are crucial to the merger's future success.

- **Execute a Poison Pill or Some Other Hostile Takeover Defense** – A poison pill scheme can be triggered by a target company when a hostile suitor acquires a predetermined percentage of company stock. To execute its defense, the target company grants all shareholders - except the acquiring company - options to buy additional stock at a dramatic discount. This dilutes the acquiring company's share and intercepts its control of the company.

- **Find a White Knight** - As an alternative, the target company's management may seek out a friendlier potential acquiring company, or white knight. If a white knight is found, it will offer an equal or higher price for the shares than the hostile bidder.

Mergers and acquisitions can face scrutiny from regulatory bodies. For example, if the two biggest long-distance companies in the U.S., AT&T and Sprint, wanted to merge, the deal would require approval from the Federal Communications Commission (FCC). The FCC would probably regard a merger of the two giants as the creation of a monopoly or, at the very least, a threat to competition in the industry.

Closing the Deal
Finally, once the target company agrees to the tender offer and regulatory requirements are met, the merger deal will be executed by means of some transaction. In a merger in which one company buys another, the acquiring company will pay for the target company's shares with cash, stock or both.

A cash-for-stock transaction is fairly straightforward: target company shareholders receive a cash payment for each share purchased. This transaction is treated as a taxable sale of the shares of the target company.

If the transaction is made with stock instead of cash, then it's not taxable. There is simply an exchange of share certificates. The desire to steer clear of the tax man explains why so many M&A deals are carried out as stock-for-stock transactions.

When a company is purchased with stock, new shares from the acquiring company's stock are issued directly to the target company's shareholders, or the new shares are sent to a broker who manages them for target company shareholders. The shareholders of the target company are only taxed when they sell their new shares.

When the deal is closed, investors usually receive a new stock in their portfolios - the acquiring company's expanded stock. Sometimes investors will get new stock identifying a new corporate entity that is created by the M&A deal.

Break Ups

As mergers capture the imagination of many investors and companies, the idea of getting smaller might seem counterintuitive. But corporate break-ups, or de-mergers, can be very attractive options for companies and their shareholders.

Advantages
The rationale behind a spinoff, tracking stock or carve-out is that "the parts are greater than the whole." These corporate restructuring techniques, which involve the separation of a business unit or subsidiary from the parent, can help a company raise additional equity funds. A break-up can also boost a company's valuation by providing powerful incentives to the people who work in the

separating unit, and help the parent's management to focus on core operations.

Most importantly, shareholders get better information about the business unit because it issues separate financial statements. This is particularly useful when a company's traditional line of business differs from the separated business unit. With separate financial disclosure, investors are better equipped to gauge the value of the parent corporation. The parent company might attract more investors and, ultimately, more capital.

Also, separating a subsidiary from its parent can reduce internal competition for corporate funds. For investors, that's great news: it curbs the kind of negative internal wrangling that can compromise the unity and productivity of a company.

For employees of the new separate entity, there is a publicly traded stock to motivate and reward them. Stock options in the parent often provide little incentive to subsidiary managers, especially because their efforts are buried in the firm's overall performance.

Disadvantages
That said, de-merged firms are likely to be substantially smaller than their parents, possibly making it harder to tap credit markets and costlier finance that may be affordable only for larger companies. And the smaller size of the firm may mean it has less representation on major indexes, making it more difficult to attract interest from institutional investors.

Meanwhile, there are the extra costs that the parts of the business face if separated. When a firm divides itself into smaller units, it may be losing the synergy that it had as a larger entity. For instance, the division of expenses such as marketing, administration and research and development (R&D) into different business units may cause redundant costs without increasing overall revenues.

Restructuring Methods
There are several restructuring methods: doing an outright sell-off, doing an equity carve-out, spinning off a unit to existing shareholders or issuing tracking stock. Each has advantages and disadvantages for companies and investors. All of these deals are quite complex.

Sell-Offs
A sell-off, also known as a divestiture, is the outright sale of a company subsidiary. Normally, sell-offs are done because the subsidiary doesn't fit into the parent company's core strategy. The market may be undervaluing the combined businesses due to a lack of synergy between the parent and subsidiary. As a result, management and the board decide that the subsidiary is better off under different ownership.

Besides getting rid of an unwanted subsidiary, sell-offs also raise cash, which can be used to pay off debt. In the late 1980s and early 1990s, corporate raiders would use debt to finance acquisitions. Then, after making a purchase they would sell-off its subsidiaries to raise cash to service the debt. The raiders' method certainly makes sense if the sum of the parts is greater than the whole. When it isn't, deals are unsuccessful.

Equity Carve-Outs

More and more companies are using equity carve-outs to boost shareholder value. A parent firm makes a subsidiary public through an initial public offering (IPO) of shares, amounting to a partial sell-off. A new publicly-listed company is created, but the parent keeps a controlling stake in the newly traded subsidiary.

A carve-out is a strategic avenue a parent firm may take when one of its subsidiaries is growing faster and carrying higher valuations than other businesses owned by the parent. A carve-out generates cash because shares in the subsidiary are sold to the public, but the issue also unlocks the value of the subsidiary unit and enhances the parent's shareholder value.

The new legal entity of a carve-out has a separate board, but in most carve-outs, the parent retains some control. In these cases, some portion of the parent firm's board of directors may be shared. Since the parent has a controlling stake, meaning both firms have common shareholders, the connection between the two will likely be strong.

That said, sometimes companies carve-out a subsidiary not because it's doing well, but because it is a burden. Such an intention won't lead to a successful result, especially if a carved-out subsidiary is too loaded with debt, or had trouble even when it was a part of the parent and is lacking an established track record for growing revenues and profits.

Carve-outs can also create unexpected friction between the parent and subsidiary. Problems can arise as managers of the carved-out company must be accountable to their public shareholders as well as the owners of the parent company. This can create divided loyalties.

Spinoffs

A spinoff occurs when a subsidiary becomes an independent entity. The parent firm distributes shares of the subsidiary to its shareholders through a stock dividend. Since this transaction is a dividend distribution, no cash is generated. Thus, spinoffs are unlikely to be used when a firm needs to finance growth or deals. Like the carve-out, the subsidiary becomes a separate legal entity with a distinct management and board.

Like carve-outs, spinoffs are usually about separating a healthy operation. In most cases, spinoffs unlock hidden shareholder value. For the parent company, it sharpens management focus. For the spinoff company, management doesn't have to compete for the parent's attention and capital. Once they are set free, managers can explore new opportunities.

Investors, however, should beware of throw-away subsidiaries the parent created to separate legal liability or to off-load debt. Once spinoff shares are issued to parent company shareholders, some shareholders may be tempted to quickly dump these shares on the market, depressing the share valuation.

Tracking Stock
A tracking stock is a special type of stock issued by a publicly held company to track the value of one segment of that company. The stock allows the different segments of the company to be valued differently by investors.

Let's say a slow-growth company trading at a low price-earnings ratio (P/E ratio) happens to have a fast growing business unit. The company might issue a tracking stock so the market can value the new business separately from the old one and at a significantly higher P/E rating.

Why would a firm issue a tracking stock rather than spinning-off or carving-out its fast growth business for shareholders? The company retains control over the subsidiary; the two businesses can continue to enjoy synergies and share marketing, administrative support functions, a headquarters and so on. Finally, and most importantly, if the tracking stock climbs in value, the parent company can use the tracking stock it owns to make acquisitions.

Still, shareholders need to remember that tracking stocks are class B, meaning they don't grant shareholders the same voting rights as those of the main stock. Each share of tracking stock may have only a half or a quarter of a vote. In rare cases, holders of tracking stock have no vote at all.

Why They Can Fail

It's no secret that plenty of mergers don't work. Those who advocate mergers will argue that the merger will cut costs or boost revenues by more than enough to justify the price premium. It can sound so simple: just combine computer systems, merge a few departments, use sheer size to force down the price of supplies and the merged giant should be more profitable than its parts. In theory, 1+1 = 3 sounds great, but in practice, things can go awry.

Historical trends show that roughly two thirds of big mergers will disappoint on their own terms, which means they will lose value on the stock market. The motivations that drive mergers can be flawed and efficiencies from economies of scale may prove elusive. In many cases, the problems associated with trying to make merged companies work are all too concrete.

Flawed Intentions
For starters, a booming stock market encourages mergers, which can spell trouble. Deals done with highly rated stock as currency are easy and cheap, but the strategic thinking behind them may be easy and cheap too. Also, mergers are often attempt to imitate: somebody else has done a big merger, which prompts other top executives to follow suit.

A merger may often have more to do with glory-seeking than business strategy. The executive ego, which is boosted by buying the competition, is a major force in M&A, especially when combined with the influences from the bankers, lawyers and other assorted advisers who can earn big fees from clients engaged in mergers. Most CEOs get to where they are because they want to be the biggest and the best, and many top executives get a big bonus for merger deals, no matter what happens to the share price later.

On the other side of the coin, mergers can be driven by generalized fear. Globalization, the arrival of new technological developments or a fast-changing economic landscape that makes the outlook uncertain are all factors that can create a strong incentive for defensive mergers. Sometimes the management team feels they have no choice and must acquire a rival before being acquired. The idea is that only big players will survive a more competitive world.

The Obstacles to Making it Work
Coping with a merger can make top managers spread their time too thinly and neglect their core business, spelling doom. Too often, potential difficulties seem trivial to managers caught up in the thrill of the big deal.

The chances for success are further hampered if the corporate cultures of the companies are very different. When a company is acquired, the decision is typically based on product or market synergies, but cultural differences are often ignored. It's a mistake to assume that personnel issues are easily overcome. For example, employees at a target company might be accustomed to easy access to top management, flexible work schedules or even a relaxed dress code. These aspects of a working environment may not seem significant, but if new management removes them, the result can be resentment and shrinking productivity.

More insight into the failure of mergers is found in the highly acclaimed study from McKinsey, a global consultancy. The study concludes that companies often focus too intently on cutting costs following mergers, while revenues, and ultimately, profits, suffer. Merging companies can focus on integration and cost-cutting so much that they neglect day-to-day business, thereby prompting nervous customers to flee. This loss of revenue momentum is one reason so many mergers fail to create value for shareholders.

But remember, not all mergers fail. Size and global reach can be advantageous, and strong managers can often squeeze greater efficiency out of badly run rivals. Nevertheless, the promises made by deal makers demand the careful scrutiny of investors. The success of mergers depends on how realistic the deal makers are and how well they can integrate two companies while maintaining day-to-day operations.

Conclusion

One size doesn't fit all. Many companies find that the best way to get ahead is to expand ownership boundaries through mergers and acquisitions. For others, separating the public ownership of a subsidiary or business segment offers more advantages. At least in theory, mergers create synergies and economies of scale, expanding operations and cutting costs. Investors can take comfort in the idea that a merger will deliver enhanced market power.

By contrast, de-merged companies often enjoy improved operating performance thanks to redesigned management incentives. Additional capital can fund growth organically or through acquisition. Meanwhile, investors benefit from the improved information flow from de-merged companies.

M&A comes in all shapes and sizes, and investors need to consider the complex issues involved in M&A. The most beneficial form of equity structure involves a complete analysis of the costs and benefits associated with the deals.

Let's re-cap what we learned in this tutorial:

- A merger can happen when two companies decide to combine into one entity or when one company buys another. An acquisition always involves the purchase of one company by another.
- The functions of synergy allow for the enhanced cost efficiency of a new entity made from two smaller ones - synergy is the logic behind mergers and acquisitions.
- Acquiring companies use various methods to value their targets. Some of these methods are based on comparative ratios - such as the P/E and P/S ratios - replacement cost or discounted cash flow analysis.

- An M&A deal can be executed by means of a cash transaction, stock-for-stock transaction or a combination of both. A transaction struck with stock is not taxable.
- Break up or de-merger strategies can provide companies with opportunities to raise additional equity funds, unlock hidden shareholder value and sharpen management focus. De-mergers can occur by means of divestitures, carve-outs spinoffs or tracking stocks.
- Mergers can fail for many reasons including a lack of management foresight, the inability to overcome practical challenges and loss of revenue momentum from a neglect of day-to-day operations.