Certified Merger and Acquisition Analyst Sample Material

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1. INTRODUCTION TO M&A

Mergers and Acquisitions are popularly referred to in their abbreviated form as M&A in the corporate world. Merger is, when two or more companies combine together by mutual consent. In this one company acquires the other company by giving away its stocks in exchange of the shares of the other company.

Acquisition is, when a bigger established company buys most of the securities of a smaller company and takes it under its wings and controls the smaller company. This is done with the idea of establishing a higher market share without having to expand its own operations and technology. This is much easier for the established firm as it automatically acquires the smaller firm's market share and adds it into its own.

Often people talk of mergers and acquisitions in the same breath and treat them as synonymous. There is a very fine line of difference between mergers and acquisitions so it becomes more important to value, negotiate and structure a clients transaction accordingly. Some of the differences between Merger and Acquisition are illustrated below.

Basis of Distinction	Merger	Acquisition
Definition	Merger is when two established companies come together with the idea of expanding their business and decide to operate as one entity.	Acquisition is where one company completely takes over the other company and the company that is financially powerful takes complete control.
Power and Profits	There is equal sharing of profits in the newly formed company.	The two companies work under the name of the powerful company and the bigger company takes over the stocks of the weaker company.

Basis of Distinction	Merger	Acquisition
Purpose	In a merger two companies of the same size combine to increase their strength and financial gains along with breaking the trade barriers.	In an acquisition usually two companies of different sizes come together to combat the challenges of the downturn
Association	In case of mergers there is a friendly association where both the partners hold the same percentage of ownership and equal profit share.	In case of acquisitions the deal is generally done in an unfriendly manner. It is more or less a forceful or helpless association where a powerful company either swallows the operation or a company in loss is forced to sell its entity.
Stocks	In case of mergers, the stocks of the two firms merging together are surrendered.	In acquisitions, the stocks of the acquired firm are not surrendered.
Cost	Mergers are typically more expensive with parties incurring higher legal cost	Acquisitions are typically less expensive in comparison to Mergers

1.1 Motivation behind M&A

The main motive behind M&A is economic growth. This can be done in many ways.

- ✓ Reduction of fixed costs by removal of duplicate departments and operations.
- ✓ Increasing the market shares
- ✓ Selling the first company's products to the customers of the other company and vice versa. This is called cross selling.
- ✓ Improving the marketing and distribution aspect of the company according to the demand.
- ✓ Reducing the tax liability by taking over a company that is under loss

- ✓ Expanding the company to other markets by diversifying geographically.

1.2 Fundamentals of M&A

M&A is an important part of the corporate world today, when the competition is high and stakes even higher. Companies want results quickly and instead of spending time on acquiring the necessary competence to increase productivity and market share, they prefer to acquire companies which are already competent enough and meet their specifications but due to some problem are not able to make a mark on their own. These kinds of deals involve lots of money and they also decide the future of the companies involved. While planning a merger or an acquisition, accounting, business, legal and tax considerations need to be perused intricately.

1.2.1 Concept of Merger

A merger is a combination of two or more businesses into one business. Laws in India use the term 'amalgamation' for merger. The Income Tax Act,1961 [Section 2(1A)]defines amalgamation as the merger of one or more companies with another or the merger of two or more companies to form a new company, in such a way that all assets and liabilities of the amalgamating companies become assets and liabilities of the amalgamated company and shareholders not less than nine-tenths in value of the shares in the amalgamating company or companies become shareholders of the amalgamated company.

Thus, mergers or amalgamations may take two forms

- ✓ Merger through Absorption: Absorption is a combination of two or more companies into an 'existing company'. All companies except one lose their identity in such a merger.
- ✓ Merger through Consolidation: A consolidation is a combination of two or more companies into a 'new company'. In this form of merger, all companies are legally dissolved and a new entity is created. Here, the acquired company transfers its assets, liabilities and shares to the acquiring company for cash or exchange of shares.

1.2.2 Strategies for Acquisition

Acquisition is not an event but a process. Companies are like human beings. When trained in a given discipline, they perform incredibly well. If you ask them to do tasks they have not done before, the probability of a successful outcome is fleetingly small. To avoid that pitfall in M&A, companies have to make a long-term commitment in many acquisitions. That way, the entire organization can learn and adapt to the strains of the process and eventually make it a core competence. Assuming that the company is committed to the multi-M&A process, there are six extremely important principles that underlie a successful acquisition strategy.

- ✓ Before entering in to any acquisition deal, the target company's market performance and market position is required to be examined thoroughly so that the optimal target company can be chosen and the deal can be finalized at a right price.
- ✓ Identification of future market opportunities, recent market trends and customer's reaction to the company's products are also very important in order to assess the growth potential of the company.
- ✓ After finalizing the acquisition deal, the integration process of the companies should be started in time. Before the closing of the deal, when the negotiation process is on, from that time, the management of both the companies requires to work on a proper integration strategy. This is to ensure that no potential problem crop up after the closing of the deal.
- ✓ If the company which intends to acquire the target firm plans restructuring of the target company, then this plan should be declared and implemented within the period of acquisition to avoid uncertainties.
- ✓ It is also very important to consider the working environment and culture of the workforce of the target company, at the time of drawing up acquisition strategies, so that the laborers of the target company do not feel left out and become demoralized.

1.2.3 Value Drivers in M&A

The main objective of a buyer in an M&A transaction is to maximize the returns in the investment. The elements of returns include

- ✓ Price paid to seller
- ✓ Cash flow generated over the course of investment
- ✓ Exit Value – Price received when the investment is sold

The current value of an M&A market is driven by the evaluation of buyers as to what price they need to pay to acquire the assets, what cash flows they feel they can generate over the course of investment, and what value they feel they can realize when they want to exit.

Evaluating a company is a complex process. It is necessary to keep these value drivers in mind while contemplating any type of M&A.

- ✓ Barriers to Entry: A company is seen as more valuable if it is tough for its competitors to enter the industry. These barriers may be due to the know-how that the company has achieved over the years or due to personal relationships.
- ✓ Competitive Environment: If the company has many competitors with everyone undercutting each other on prices and margin, then the value of the company is low. On the other hand, the company with a unique geographic or product niche or a dominant market share is considered to have a higher value.
- ✓ Financeability: The degree to which a company can be financially leveraged with debt may have a significant impact on the value of the company. Private equity groups acquire companies utilizing debt sources. Companies with lower debt capacity require more equity which drives returns low.
- ✓ Geography: Location of a company has different aspects as it relates to value of the company. There is a location for the market place – whether the company is tied to any one region that is attractive or not. If sales are geographically diversified then the economic conditions in any one area will not adversely affect the earnings. If most of the operations are situated in high cost areas of the country then this may be seen as unfavorable as it relates to cost structure.
- ✓ Growth Prospects: Growth drives multiples. Public companies with higher growth prospects have higher PE multiples. Private markets are the same. The higher the perception of growth opportunities, the greater the value of the company.
- ✓ Industry: Industries come in and out of favor usually because of the perceptions of the market related to growth prospects. The value of a good company in a bad industry is often a tough issue than the value of a mediocre company in a attractive industry.
- ✓ Institutional Ownership: Industries with institutional involvement, whether private or public, are considered to have higher value. Smaller companies with larger institutional ownership often benefit from this.
- ✓ Management: Depth of management is important as it relates to value of the company. The greatest, most profitable company's value could be diminished due to the lack of depth in the management, which is required for continuity. Along with management a

company should have related systems, procedures, and processes to ensure that the business is not overly dependent on one individual.

- ✓ Profitability: Profits are the most important component taken into consideration while determining a company's worth. Good, steady and growing profits are critical elements for the value of a company.
- ✓ Size: The bigger the company the higher the value as there is more money chasing the bigger deals.

1.3 Types of M&A Deals

There are various types of M&A deals depending upon the companies involved in the deal.

1.3.1 Types of Mergers

Some types of mergers which are very significant in today's corporate sector are

- ✓ Horizontal Mergers: Horizontal M&A is the one which takes place between two companies in the same field. For example, if a paint company merges with another paint company, it is known as a horizontal merger. In this kind of merging the companies involved combine their operations and also gain in terms of increased productivity, increased capital, increased market share and profit. Also this means a reduction in the number of competitors which is highly beneficial for the companies involved.
- ✓ Vertical Mergers: Vertical M&A involve merging of companies which work in the same field but under different sections. Citing the earlier example, if a paint company which sells paint for painting houses combines with a company which produces automobile paints, then this is called a Vertical Merger. The significance of this kind of a Merger is that it reduces overheads and also brings all the required operations and productions under one roof.
- ✓ Accretive Mergers: A merger is accretive when a firm with a higher price to earnings ratio acquires a firm of a lower P/E ratio. The company's new earnings will be the sum of the earnings of the two firms. Usually, the new company will maintain the P/E ratio of the acquiring firm. Post-acquisition, it will be valued as P/E of acquiring firm x earnings. However, the amount that acquiring company had to pay was only P/E of the acquired firm x Earnings of the acquired firm. Hence it paid a lower price when compared to the additional valuation it received from the market due to the increased

earnings. Hence the merger is known as accretive merger as it adds value to the acquiring firm.

- ✓ Dilutive Mergers: The reverse of accretive merger is a dilutive merger, and occurs when a company with a lower P/E ratio buys a firm with a higher P/E ratio.
- ✓ Conglomerate M&A: Conglomerate M&A involves two companies merging together which are not related in any way as far as their operations and products are concerned. For example, if a paint company acquires a pharmaceutical company, this is a conglomerate M&A. Here the basic idea is to divert the capital in a different direction but under the name of one enterprise. The different types of conglomerate mergers are as follows
  - ✓ Mixed Conglomerate Mergers - A mixed merger is a type of conglomerate merger which occurs between two companies that want to reach a wider market and audience through product extensions or market extensions. For example, if a cable company wants to move into the live performance market, then it could merge with a company that owns a production companies. Thus, a mixed merger would be born.
  - ✓ Pure Conglomerate Mergers - The pure conglomerate merger is one where two companies merge in which they have nothing in common at all -- their businesses are completely unrelated to each other. For example, if a cable company merged with a furniture manufacturer, then the merger would be considered a pure conglomeration merger.
  - ✓ Financial Conglomerate Mergers – Financial Conglomerate mergers happen when one company provides cash to the other, but does not interfere with business operations. It has no control over the business's activities and is more like an investor.
  - ✓ Managerial Conglomerate Mergers – Managerial Conglomerate mergers are one in which both money and other resources - like labor and land - are exchanged between the two businesses. With this subdivision, executives and managerial staff from one firm may move to the other after the merger is complete.

1.3.2 Types of Mergers

The various types of acquisitions prevalent are

- Asset Acquisition: In an asset acquisition, individually identified assets and liabilities of the seller are sold to the acquirer. The acquirer can choose which specific assets and liabilities it wants to purchase, avoiding unwanted assets and liabilities for which it does not need to assume responsibility. The asset purchase agreement between the buyer and seller will list and assign values to each asset or liability to be acquired, including every asset from office supplies to goodwill.
- Stock Acquisition: In a stock acquisition, all of the assets and liabilities of the seller are sold upon transfer of the seller's stock to the acquirer. As such, no tedious valuation of the seller's individual assets and liabilities is required and the transaction is mechanically simple.

1.4 Stages in M&A

The process of M&A comprises of two phases

- **Planning Phase:** The Planning phase involves development of appropriate strategies for merger and acquisition for a smooth process flow and with an objective to attain the ultimate goal. The planning phase involves
  - *Business Plan Development:* It is necessary to develop a business plan that communicates the vision and mission of the firm and the strategies proposed to achieve the mission. The process of developing a business plan deals with the determining the industry where a company wants to compete, conducting internal analysis to identify strengths and weaknesses of the organization, defining the mission statement, setting up intended objectives and identifying appropriate strategies.
- **Implementation Phase:** The implementation phase is very crucial as even great plans may fail without correct implementation of the plan. For this the company should ensure following the following steps.
  - *Searching and screening target companies:* Once the planning phase is complete then companies start identifying potential candidate for acquisition. This involves screening based on various factors such as type of industry, transaction size and location. The acquiring company uses information from various sources such as law firms, investment banks, brokers etc for identifying prospective candidates. This

process of screening helps in finding the most suitable target from the list of companies identified for the purpose of acquisition.

- ✓ *Initiating contact:* Once the target is identified then the acquiring company should present the proposal for acquisition. There can be various ways by which a company can establish contact with the target through letter of interest, intermediary, management etc.
- ✓ *Letter of Intent:* Once the target company shows interest in the offer then the acquiring company and the target should sign a letter of intent by taking into consideration the major terms and conditions, responsibilities of both parties, non-competing clause etc.
- ✓ *Valuation:* When a company plans to take over another company, a proper valuation needs to be done, so that the company can assess how the other company's taking over will be beneficial for them. The company which is planning to take over will try to offer the lowest price whereas the company which is being acquired will try to quote a higher price.
- ✓ *Negotiating the deal:* Once valuations are more or less completed, the two sides should have cleared up any doubtful points or at least come to a consensus on them. This step involves determining the purchase consideration involving estimating total purchase consideration, total enterprise value and net purchaser price. Once the process of due diligence is through the acquirer and the target set the structure of the deal by setting the compensation plan, legal, tax and accounting structure to deal with the issues of risk and reward.
- ✓ *Developing the Integration Plan:* The integration plan is developed with the motive to understand the financial position and standing in the market. This helps the acquiring company to ascertain the maximum price that should be offered to the target company. The acquiring company should go ahead with the process of acquisition only if the Net Present Value (NPV) is greater than or equal to zero.
- ✓ *Obtaining Approvals:* It is very important to abide with the set provisions of the Company Laws and the target firm should secure consent of the shareholders, regulatory authorities, and third parties involved.

- ✓ *Closing the deal:* Once the company being acquired agrees to the offer of the acquiring company and once all the necessary regulations have been cleared the deal is closed. In this the acquiring company is required to pay the acquired company's shares with cash or stocks as promised.
- ✓ *Contract Performance and Integration:* Toward the end of the M&A process, come the contract performance and consolidation phase, meaning that, with the regulator's approval in hand, the company can close the transaction and truly wrap up the M&A deal. This is also the time to initiate the post-deal integration work, including personnel redeployment and integration of systems, processes and corporate cultures.

1.5 Challenges of M&A deal

Companies get into an M&A due to the benefits it brings to the company. But in today's corporate world there are many examples of failed M&A. So now M&A has become a big challenge. One wrong step and the whole organization can suffer. The various challenges faced are

- ✓ Often unrealistic price needs to be paid
- ✓ Maintaining economic growth of the company.
- ✓ Bringing in sync the work culture of two different organizations.
- ✓ Maintaining and increasing the production
- ✓ Retaining the talented man power
- ✓ Implementing and managing the changes
- ✓ Understanding the objectives behind the M&A
- ✓ Splitting the authorities is a difficult task as it may affect the management of the organization
- ✓ Regulatory and legal hassles slows down the process

Self-Assessment Questions

1. The complete absorption of one company by another, wherein the acquiring firm retains its identity and the acquired firm ceases to exist as a separate entity, is called a ___________.

A. Merger
B. Consolidation
C. Spin off
D. Tender offer

2. The acquisition of a firm in the same industry as the bidder is called a _________ Merger.

A. Conglomerate
B. Horizontal
C. Vertical
D. Backward

3. A public offer by one firm to directly buy the shares of another firm is called a ___________.

A. Merger
B. Consolidation
C. Tender offer
D. Divestiture

4. The acquisition of a firm whose business is not related to that of the bidder is called a __________ Merger.

A. Horizontal
B. Vertical
C. Concentric
D. Conglomerate

5. The acquisition of a firm involved with a different production process stage than the bidder is called a _____________ Merger.

A. Conglomerate
B. Vertical
C. Horizontal
D. Backward

Answer: 1 – A, 2 - B, 3 – C, 4 – D, 5 - B