# MERGERS & ACQUISITIONS

**Merger** – this a situation where two or more companies combine into one company.

## Merger/Amalgamations takes 2 forms:

a) Merger though **absorption** – combination of 2 or more companies into an existing company.

b) Merger through **consolidation** -A combination of two or more companies into a new company.

## TYPES OF MERGERS

1) Horizontal merger-a combination of two or more firms in **similar** type of production or area of business e.g 2 book publishers, 2 colleges. This is to enhance market share.

2) Vertical merger –this is a combination of two or more firms involved in **different** stages of production or distribution e.g cotton producing firm & clothing company.

3)Conglomerate merger - Combinations of firms in unrelated lives of business activity.

## Special features of M & A

- The benefits from acquisitions are called synergies
- There are complex accounting, tax and legal effects when one firm is acquired by another.
- Acquisitions are an important control device of shareholders – they can use this means to remove managers they are unhappy with.
- Acqusition analysis frequently focuses on the total value of the firms involved.
- M & A sometimes involve unfriendly transactions.
  -The sought after firm may use defensive tactics.

**Synergies = VAB – (VA + VB)**
Revenue enhancement, cost reduction, lower taxes and lower cost of capital.

Premium Paid for an acquistion = price paid – market value of the acquisition prior to the merger.

## 3 Basic legal procedures that one firm uses to acquire another firm:

1) **Merger or consolidation** - Merger refers to an absorption of one firm by another (acquiring firm retains its name and identity and acquires all the assets and liabilities of the acquired firm. After the merger, the acquired firm **ceases** to exist as a separate business entity.

   **A consolidation** – an entirely new firm is created.
   a) Merger is legally straightforward & less costly than other means
   b) Merger must be approved by shareholder of each firm

2) **Acquistion of stock** - purchase of the firm's voting stock in exchange for cash, shares of stock or other securities.

   Can start as a private offer from the management of one firm to another. At the same point, the ofer is made directly to the shareholders through a tender offer ( A public offer to buy shares of a target firm). Public announcements, e.g through Newspapers, is made to the

3) **Acquisition of Assets** - Buying all the assets of the target firm. Shareholder of the selling firm must vote. The process involves transferring tittle to assets.

## TAKEOVER

- This involves transfer of control (having majority vote on the board of directors) of a firm from one group of shareholders to another. A firm that takes over another is called a **bidder**. The bidder offers to pay cash or securities to obtain the stock or assets of another firm. If the offer is accepted, the target firm will give up control over its stock or assets in exchange for consideration (cash, stock or its debt).

- If a firm buys another firm, the transaction may be taxable or tas-free

  **Taxable acquisition** – shareholders of acquired firm are considered to have sold their shares and realized capital gains which are taxed.

  **Tax-free acquistion** – the selling shareholders are considered to have exchanged their old shares for new ones of equal value, experiencing no capital gains or losses.

## ACCOUNTING FOR ACQUISTITIONS

Acquisitions are treated as either a purchase or pooling of interests on the shareholder's books.

**a) Purchase method** It requires that the assets of the acquired firm be reported at their Fair Market Value on the books of the acquiring firm. In a purchase, Goodwill is created i.e the excess of the prchase price over the sum of the Fair market Values of the individual assets acquired – Goodwill=Purchase Price – FMV.

**b) Pooling of interests** The assets of the new firm are valued at the same levelat which they were carried on the books of the acquired and acquiring firms. The new firm is owned jointly by all the shareholders of the previously separate firms. The total assets and total equity are unchanged by the acquisition & no goodwill is created.

**a) Revenue enhancement**

Combined firms generate greater revenues than two separate firms. Can be Achieved through marketing gains, strategic benefits like taking advantage of Competitive environment & monopoly power.

**b) Cost reduction**

Combined firms operate more efficiently than 2 separate firms. Can be achieved Through economies of scale via spreading overheads, complementary resources & Elimination of inefficient management.

**c) Tax gains**

Firm (new) makes use of the unused – cost of financial distress is less for merged firm, additional tax benefits debt capacity, use of surplus funds, merging means firm pays lower taxes than what the separate firms could have paid (taking advantage of potential tax losses)

**d) Lower cost of capital**

Coc cn be reduced when 2 firms merge coz costs of issuing securities are subject to Economies of scale. Costs of issuing debt & equity are much lower for larger issues than for smaller issues.

## <u>TWO "BAD" REASONS FOR MERGERS – DUBIOUS</u>

**a) Earnings growth** – Increase in EPS doesnt mean true growth.

- An acquisition can create the appearance of earnings growth, which may dupe investors  to think that the firm is worth more that it really is. E.g x,y have 100 & 100 shares.  New Co. Shares = 140 EPS will be forward which does not necessarily imply growth.

**b) Diversification** – It is argued that diversification, by itself, cannot produce increases in value.  Systematic risk cannot be eliminated by diversification, so merges will not eliminate this risk at all.

## Defensive tactics of resisting takeover attempts

**1) Divestitures**

-Target firm managers can increase stock price, thereby making a takeover too expensive.

**2) Corporate Charter**

- They establish conditions that allow a takeover e.g 2/3 of shareholders on record must approve a merger.  Firms can ammend corporate charters to make acquisitions more difficult.

- Have a staggered selection of boardmembers hence making it difficult to elect a new board of directors quickly.

**3) Repurchase standstill agreements**

- A firm buys back its own stock from a potential bidder at a substantial premium. This forestalls a takeover attempt.

- Managers of target firms may also negotiate standstill agreements (contracts where the bidding firm agrees to limit its holdings of another firm).