B.M. Hamroyev, Senior Lecturer, TFI,
F.Ametova, TFI

MERGERS AND ACQUISITIONS AS MAJOR BUSINESS COMBINATION PROCESSES

Мақолада компанияларни ўзаро қўшилиши ва бир компанияни бошқаси томонидан ютиб юборилиши компанияларнинг бирлашиш жараёнлари сифатида кўриб чиқилган ва таҳлил этилган. Компанияларнинг қўшилиши ва бир компанияни бошқаси томонидан ютиб юборилишининг турлари ва категориялари кўриб чиқилган, шунингдек ушбу жараён босқичларга бўлинган ҳолда таърифланган. Мақолада лойиҳани амалга оширишнинг мақсадга мувофиқлигини аниқлаш учун, баҳолаш инструменти сифатида дисконтлаштиришган пул оқими модели келтирилган.

В настоящей статье описаны и проанализованы слияния и поглощения как процессы объединения компаний. Рассмотрены типы и категории слияний и поглощений, а также описан процесс слияний и поглощений с разделением на фазы. Для определения целесообразности, в качестве инструмента оценки в статье дается модель дисконтированного денежного потока.

Keywords: *merger, acquisition, conglomerate integration, synergy value, targetcompany, Due Diligence, Discounted Cash Flow, FCF, EBIT, EBITDA, WACC.*

Mergers and acquisitions represent the ultimate in change for a business. No other event is more difficult, challenging, or chaotic as a merger and acquisition. It is imperative that everyone involved in the process has a clear understanding of how the process works. Hopefully this short article will provide reader with a better appreciation of what is involved.

Mergers and acquisitions are now a normal way of life within the business world. In today's global, competitive environment, mergers are sometimes the only means for long-term survival. In other cases, such as Cisco Systems, mergers are a strategic component for generating long-term growth. Additionally, many entrepreneurs no longer build companies for the long-term; they build companies for the short-term, hoping to sell the company for huge profits.

When the term "merger" is used, it is referred to the merging of two companies where one new company will continue to exist. The term "acquisition" refers to the acquisition of assets by one company from another company. In an acquisition, both companies may continue to exist. However, it can loosely be referred to mergers and acquisitions (M&A) as a business transaction where one company acquires another company. The acquiring company will remain in business and the acquired company (which sometimes is called the Target Company) will be integrated into the acquiring company and thus, the acquired company ceases to exist after the merger.

Mergers can be categorized as follows:

Horizontal: Two firms are merged across similar products or services. Horizontal mergers are often used as a way for a company to increase its market share by merging with a competing company. For example, the merger between Exxon and Mobil will allow both companies a larger share of the oil and gas market.

Vertical: Two firms are merged along the value-chain, such as a manufacturer merging with a supplier. Vertical mergers are often used as a way to gain a competitive advantage within the marketplace. For example, Merck, a large manufacturer of pharmaceuticals, merged with Medco, a large distributor of pharmaceuticals, in order to gain an advantage in distributing its products.

Conglomerate: Two firms in completely different industries merge, such as a gas pipeline company merging with a high technology company. Conglomerates are usually used as a way to smooth out wide fluctuations in earnings and provide more consistency in long-term growth. Typically, companies in mature industries with poor prospects for growth will seek to diversify their businesses through mergers and acquisitions. For example, General Electric (GE) has diversified its businesses through mergers and acquisitions, allowing GE to get into new areas like financial services and television broadcasting.

Every merger has its own unique reasons why the combining of two companies is a good business decision. The underlying principle behind mergers and acquisitions (M&A) is simple: 2 + 2 = 5. The value of Company A is $ 2 billion and the value of Company B is $2 billion, but when we merge the two companies together, we have a total value of $5 billion. The joining or merging of the two companies creates additional value which we call "synergy" value.

Synergy value can take three forms:

1. *Revenues:* By combining the two companies, we will realize higher revenues then if the two companies operate separately.

2. *Expenses:* By combining the two companies, we will realize lower expenses then if the two companies operate separately.

3. *Cost of Capital:* By combining the two companies, we will experience a lower overall cost of capital.

The Merger & Acquisition Process can be broken down into five phases[1]*:*

Phase 1 - Pre Acquisition Review: The first step is to assess your own situation and determine if a merger and acquisition strategy should be implemented. If a company expects difficulty in the future when it comes to maintaining core competencies, market share, return on capital, or other key performance drivers, then a merger and acquisition (M&A) program may be necessary.

Phase 2 - Search & Screen Targets: The second phase within the M&A Process is to search for possible takeover candidates. Target companies must fulfill a set of criteria so that the Target Company is a good strategic fit with the acquiring company. For example, the target's drivers of performance should compliment the acquiring company. Compatibility and fit should be assessed across a range of criteria - relative size, type of business, capital structure, organizational strengths, core competencies, market channels, etc.

It is worth noting that the search and screening process is performed in-house by the Acquiring Company. Reliance on outside investment firms is kept to a minimum since the preliminary stages of M&A must be highly guarded and independent.

Phase 3 - Investigate & Value the Target: The third phase of M&A is to perform a more detail analysis of the target company. You want to confirm that the Target Company is truly a good fit with the acquiring company. This will require a more thorough review of operations, strategies, financials, and other aspects of the Target Company. This detail review is called "due diligence." Specifically, Phase I Due Diligence is initiated once a target company has been selected. The main objective is to identify various synergy values that can be realized through an M&A of the Target Company. Investment Bankers now enter into the M&A process to assist with this evaluation.

A key part of due diligence is the valuation of the target company. In the preliminary phases of M&A, we will calculate a total value for the combined company. We have already calculated a value for our company (acquiring company). We now want to calculate a value for the target as well as all other costs associated with the M&A. The calculation can be summarized as follows:

Value of Our Company (Acquiring Company)	*$560*
Value of Target Company	*$176*
Value of Synergies per Phase I Due Diligence	*$38*
Less M&A Costs (Legal, Investment Bank, etc.)	*$(9)*
Total Value of Combined Company	*$765*

Phase 4 - Acquire through Negotiation: Now that we have selected our target company, it's time to start the process of negotiating aM&A. We need to develop a negotiation plan based on several key questions:

- How much resistance will we encounter from the Target Company?
- What are the benefits of the M&A for the Target Company?
- What will be our bidding strategy?
- How much do we offer in the first round of bidding?

The most common approach to acquiring another company is for both companies to reach agreement concerning the M&A; i.e. a negotiated merger will take place. This negotiated arrangement is sometimes called a "bear hug." The negotiated merger or bear hug is the preferred approach to aM&A since having both sides agree to the deal will go a long way to making the M&A work. In cases where resistance is expected from the target, the acquiring firm will acquire a partial interest in the target; sometimes referred to as a "toehold position." This toehold position puts pressure on the target to negotiate without sending the target into panic mode.

In cases where the target is expected to strongly fight a takeover attempt, the acquiring company will make a tender offer directly to the shareholders of the target, bypassing the target's management. Tender offers are characterized by the following:

- The price offered is above the target's prevailing market price.
- The offer applies to a substantial, if not all, outstanding shares of stock.

- The offer is open for a limited period of time.
- The offer is made to the public shareholders of the target.

A few important points worth noting:

- Generally, tender offers are more expensive than negotiated M&A's due to the resistance of target management and the fact that the target is now "in play" and may attract other bidders.
- Partial offers as well as toehold positions are not as effective as a 100% acquisition of "any and all" outstanding shares. When an acquiring firm makes a 100% offer for the outstanding stock of the target, it is very difficult to turn this type of offer down.

Another important element when two companies merge is Phase II Due Diligence. As you may recall, Phase I Due Diligence started when we selected our target company. Once we start the negotiation process with the target company, a much more intense level of due diligence (Phase II) will begin. Both companies, assuming a merger is negotiated, will launch a very detail review to determine if the proposed merger will work. This requires a very detailed review of the target company - financials, operations, corporate culture, strategic issues, etc.

Phase 5 - Post Merger Integration: If all goes well, the two companies will announce an agreement to merge the two companies. The deal is finalized in a formal merger and acquisition agreement. This leads to the fifth and final phase within the M&A Process, the integration of the two companies.

Every company is different - differences in culture, differences in information systems, differences in strategies, etc. As a result, the Post Merger Integration Phase is the most difficult phase within the M&A Process. Now all of a sudden we have to bring these two companies together and make the whole thing work. This requires extensive planning and design throughout the entire organization. The integration process can take place at three levels:

1. *Full:* All functional areas (operations, marketing, finance, human resources, etc.) will be merged into one new company. The new company will use the "best practices" between the two companies.
2. *Moderate:* Certain key functions or processes (such as production) will be merged together. Strategic decisions will be centralized within one company, but day to day operating decisions will remain autonomous.
3. *Minimal:* Only selected personnel will be merged together in order to reduce redundancies. Both strategic and operating decisions will remain decentralized and autonomous.

If postmerger integration is successful, then we should generate synergy values. However, before we embark on a formal merger and acquisition program, perhaps we need to understand the realities of mergers and acquisitions.

We need to assign a value or more specifically a range of values to the Target Company sothat we can guide the merger and acquisition process. We need answers to severalquestions: How much should we pay for the target company, how much is the target worth,how does this compare to the current market value of the target company, etc.?It should be noted that the valuation process is not intended to establish a selling

price for theTarget Company. In the end, the price paid is whatever the buyer and the seller agree to.

What do Daimler-Benz, Hewlett-Packard (HP), Microsoft, Quaker Oats, and Sprint have in common? They are all multinational companies with established brands and products. But they have something else in common: They have all made bad acquisitions! In 1994, Quaker Oats acquired Snapple for $1.7 billion; it sold Snapple to an investment company for only $300 million two years later. Daimler purchased Chrysler for $36 billion in 1998; it got only $7.4 billion when it sold 80 percent of Chrysler to a private equity firm nine years later. HP, Sprint, and Microsoft also failed to make their acquisitions of Electronic Data System, Nextel Communications, and aQuantive work. These companies had to write off a significant portion of the price they paid for their targets—58, 86, and 98 percent, respectively. Unfortunately, these examples are not exceptional. Bad acquisitions happen in all countries, in all industries, and during both bull and bear markets[2].

Acquisitions fail for different reasons, but one recurrent theme is that acquirers overpay for the target. They overestimate either the target’s value, the expected synergies associated with the acquisition, or both. When the benefits of the acquisition fail to materialize, an acquirer has to write off part, and sometimes all, of the purchase price. Some companies, such as Quaker Oats and Daimler, might be able to recoup at least a small portion of the loss; others are not so fortunate and end up shuttering the business they acquired.

However, that all mergers and acquisitions are bound to fail. Some of the strongest companies as of this writing are the result of large M&As: The combinations of Exxon and Mobil in 1998, Vodafone and Mannesmann in 1999, Pfizer and Warner Lambert in 1999, and JPMorgan Chase and Bank One in 2004 created leaders in the oil and gas, telecommunication, pharmaceutical, and banking industries, respectively. Acquisitions that are well planned and well executed offer companies the opportunity to grow successfully. One of the critical aspects of the planning stage is the valuation of the target and the expected synergies between the acquirer and the target.

Overpaying for the acquisition is a common mistake because of an incomplete valuation model. Therefore, it is essential to develop a complete valuation model, including analysis under different scenarios with recognition of value drivers. A good starting point for determining value is to extend the Discounted Cash Flow Model since it corresponds well to market values.

The valuation decision is treated as a capital budgeting decision using the Discounted Cash Flow (DCF) Model. The reason why we use the DCF Model for valuation is because:

- Discounted Cash Flow captures all of the elements important to valuation.
- Discounted Cash Flow is based on the concept that investments add value when returnsexceed the cost of capital.
- Discounted Cash Flow has support from both research and within the marketplace.

The valuation computation includes the following steps[3]:

1. Discounting the future expected cash flows over a forecast period.

2. Adding a terminal value to cover the period beyond the forecast period.

3. Adding investment income, excess cash, and other non-operating assets at their presentvalues.

4. Subtracting out the fair market values of debt so that we can arrive at the value of equity.

Before we get into the valuation computation, we need to ask: What are we trying to value?Do we want to assign value to the equity of the target? Do we value the Target Company ona long-term basis or a short-term basis? For example, the valuation of a company expectedto be liquidated is different from the valuation of a going concern.

Most mergers and acquisitions are directed at acquiring the equity of the Target Company.However, when you acquire ownership (equity) of the Target Company, you will assume theoutstanding liabilities of the target. This will increase the purchase price of the TargetCompany.

One of the dilemmas within the merger and acquisition process is selection of income streams for discounting. Income streams include Earnings, Earnings Before Interest & Taxes (EBIT), Earnings Before Interest Taxes Depreciation & Amortization (EBITDA), Operating Cash Flow, Free Cash Flow, Economic Value Added (EVA), etc.

One of the more reliable cash flows for valuations is Free Cash Flow (FCF). FCF accounts forfuture investments that must be made to sustain cash flow. Compare this to EBITDA, whichignores any and all future required investments. Consequently, FCF is considerably morereliable than EBITDA and other earnings-based income streams. The basic formula forcalculating Free Cash Flow (FCF) is[4]:

FCF = EBIT (1 - t) + Depreciation - Capital Expenditures + or - Net Working Capital

(1 - t) is the after tax percent, used to convert EBIT to after taxes.Depreciation is added back since this is a non-cash flow item within EBITCapital Expenditures represent investments that must be made to replenish assets andgenerate future revenues and cash flows.

Net Working Capital requirements may be involved when we make capital investments. Atthe end of a capital project, the change to working capital may get reversed.

Example: Calculation of Free Cash Flow

EBIT $ 400
Less Cash Taxes (130)
Operating Profits after taxes 270
Add Back Depreciation 75
Gross Cash Flow 345
Change in Working Capital 42
Capital Expenditures (270)
Operating Free Cash Flow 117
*Cash from Non Operating Assets * 10*

Free Cash Flow$ 127

** Investments in Marketable Securities*

In addition to paying out cash for capital investments, we may find that we have some fixedobligations. A different approach to calculating Free Cash Flow is:

FCF = After Tax Operating Tax Cash Flow - Interest (1 - t) - PD - RP - RD – E[4]

PD: Preferred Stock Dividends

RP: Expected Redemption of Preferred Stock

RD: Expected Redemption of Debt

E: Expenditures required to sustain cash flows

Now that we have some idea of our income stream for valuing the Target Company, we needto determine the discount rate for calculating present values. The discount rate used shouldmatch the risk associated with the free cash flows. If the expected free cash flows are highlyuncertain, this increases risk and increases the discount rate. The riskier the investment, thehigher the discount rate and vice versa. Another way of looking at this is to ask yourself -What rate of return do investors require for a similar type of investment?

Since valuation of the target's equity is often the objective within the valuation process, it isuseful to focus our attention on the "targeted" capital structure of the Target Company. Areview of comparable firms in the marketplace can help ascertain targeted capital structures.Based on this capital structure, we can calculate an overall weighted average cost of capital(WACC). The WACC will serve as our base for discounting the free cash flows of the TargetCompany.

Valuing a target company is more or less an extension of what we know from capitalbudgeting. If the Net Present Value of the investment is positive, we add value through amerger and acquisition.

Example: - Calculate Net Present Value

Shannon Corporation is considering acquiring Dalton Company for $100,000 in cash. Dalton's cost of capital is 16%. Based on market analysis,a targeted cost of capital for Dalton is 12%. Shannon has estimated thatDalton can generate $ 9,000 of free cash flows over the next 12 years.

Using Net Present Value, should Shannon acquire Dalton?

Initial Cash Outlay $ (100,000)

*FCF of $ 9,000 x 6.1944 * 55,750*

Net Present Value $ (44,250)

** present value factor of annuity at 12%, 12 years.*

Based on NPV, Shannon should not acquire Dalton since there is anegative NPV for this investment.

In conclusion,it can said thatmergers and acquisitions are among the most difficult of business transactions. There is no shortage of stress. All of a sudden a new company must be formed with:

- Newer and more ambitious financial goals.
- Quicker turnaround times for growth.
- Restructuring of departments and the old company.

- Introduction of cultural differences.
- Higher rates of employee turnover.
- Lower levels of productivity.
- Communication problems.

There are numerous reasons why companies decide to merge. Some studies indicate that companies merge for improving efficiencies and lowering costs. Other studies show that companies merge to increase market share and gain a competitive advantage. The ultimate goal behind a merger and acquisition is to generate synergy values. Good strategic planning is the key to understanding if synergy values do in fact exist. A well-researched and realistic plan will dramatically improve the chances of realizing synergy values.

There are many ways to value a business, which can yield widely varying results, depending upon the basis of each valuation method. Some methods assume a valuation based on the assumption that a business will be sold off at bankruptcy prices, while other methods focus on the inherent value of intellectual property and the strength of a company’s brands, which can yield much higher valuations.

Some key points to remember in the valuation process include:

1. Most valuations will focus on valuing the equity of the Target Company.
2. The discount rate used should match-up with the associated risk of cash flows.
3. The forecast should focus on long-term cash flows over a period of time that captures anormal operating cycle for the company.
4. The forecast should be realistic by fitting with historical facts.
5. A comprehensive model is required based on an understanding of what drives value for the company.
6. The final forecast should be tested against independent sources.

Being the main goal of a company which starts negotiating in a market is the creation of value to the shareholders, has led organizations to start looking at different forms of creating and at the same time, increasing the value. Among a set of strategies, Mergers and Acquisitions were considered as a coherent and sophisticated strategy, allowing creating value not only for the acquiring company, but also for the target company.

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