



Subject: Business finance 1

Chapter: Unit 4

Category: Practice question solution

Answer 8

- (i) **Synergy:** The condition wherein the whole is greater than the sum of its parts; in a synergistic merger, the post-merger value exceeds the sum of the separate companies' premerger values.

Merger: The combination of two or more firms to form a single firm.

- (ii) **Horizontal Merger:** A combination of two firms that produce the same type of good or service.

Vertical Merger: A merger between a firm and one of its suppliers or customers.

Congeneric Merger: A merger of firms in the same general industry, but for which no customer or supplier relationship exists.

Conglomerate Merger: A merger of companies in totally different industries.

- (iii) **Friendly Merger:** A merger whose terms are approved by the managements of both companies.

Hostile Merger: A merger in which the target firm's management resists acquisition.

Tender Offer: The offer of one firm to buy the stock of another by going directly to the stockholders, frequently (but not always) over the opposition of the target company's management.

Acquiring Company: A company that seeks to acquire another firm.

Target Company: A firm that another company seeks to acquire.

- (iv) **Financial Merger:** A merger in which the firms involved will not be operated as a single unit and from which no operating economies are expected.

Operating Merger: A merger in which operations of the firms involved are integrated in hope of achieving synergistic benefits.

Equity Residual Method: A method used to value a target firm using cash flows that are residuals and belong solely to the acquiring firm's shareholders.

Market Multiple Analysis: A method of valuing a target company that applies a market determined multiple to net income, earnings per share, sales, book value, and so forth.

- (v) **White Knight:** A company that is acceptable to the management of a firm under threat of a hostile takeover and that will compete with the potential acquirer.

White Squire: An individual or company who is friendly to current management and will buy enough of the target firm's shares to block a hostile takeover.

Poison Pill: An action that will seriously hurt a company if it is acquired by another.

Golden Parachutes: Large payments made to the managers of a target firm if it is acquired.

- (vi) **Arbitrage:** The simultaneous buying and selling of the same commodity or security in two different markets at different prices and pocketing a risk-free return.

- (vii) **Corporate, or Strategic, Alliances:** Cooperative deals that stop short of a merger.

Joint Venture: A corporate alliance in which two or more independent companies combine their resources to achieve a specific, limited objective.

- (viii) **Divestiture:** The sale of some of a company's operating assets.

Spin-Off: A divestiture in which the stock of a subsidiary is given to the parent company's stockholders.

Carve-Out: A minority interest in a corporate subsidiary is sold to new shareholders, so the parent gains new equity financing yet retains control.

Liquidation: Occurs when the assets of a division are sold off piecemeal, rather than as an operating entity.

Leveraged Buyout (LBO): A situation in which a small group of investors (which usually includes the firm's managers) borrows heavily to buy all the shares of a company.

Answer 9:

Internal growth occurs when a business expands its own operations rather than by operating with other business. This can be achieved in three ways. A firm can expand by:

- Horizontal expansion, i.e. by increasing production of goods or services at the same stage of the production process, e.g. a food manufacturer.
- Vertical expansion, i.e. by developing new operations at a different stage in the production

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process, e.g. a food manufacturer might move backwards into farming or forwards into retailing.

- Diversification, i.e. by moving into completely different markets, e.g. a mail-order business might expand into radio stations, trains, airlines and banking.

Answer 10:

External growth occurs when a firm merges with, takes over or works jointly with another firm or firms. This integration can take the same three forms as above:

- Horizontal integration involves two or more firms at the same stage of the production process in the same industry, e.g. two car manufacturers.
- Vertical integration involves two or more firms at different stages of the same production process in the same industry, e.g. a car manufacturer and a supplier of car components, or a car manufacturer and a car retailer.
- Conglomerate integration involves two or more firms in completely different industries, e.g. a car manufacturer and a hotel chain.

Answer 11:

When evaluating a potential target company, an acquirer might consider the following factors:

- Resources: The acquisitions of additional (perhaps unique) resources, e.g. technology, raw materials, patents, licences, expertise, experience, reputation in a particular market/location.
- Costs: The ability to reduce costs, e.g. economics of scale arising from horizontal integration, cheaper raw materials or labour in a different location, the ability to produce and sell within another country and thereby avoid trade barriers, the possibility of reducing tax if residency is switched to the target's country.
- Market: The potential for extending the market, e.g. to a new segment or location and/or the ability to serve large clients/customers.
- Security: The potential to increase certainty and reduce transactions costs, e.g. the greater control of supplies/outlets arising from vertical integration; or the opportunity to decrease the number of competitors in the market by horizontal integration; or the ability to spread risk by conglomerate integration.
- Compatibility: The compatibility of management style, culture, remuneration packages.

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Cash is used in the following form in the short term:

Payments of accounts payable: Dynamic has to pay its bills for raw materials, parts, electricity, and so on. The cash-flow forecast assumes all these bills are paid on time, although Dynamic could probably delay payment to some extent. Delayed payment is sometimes called stretching payables. Stretching is one source of short-term financing, but for most firms, it is an expensive source because, by stretching, they lose discounts given to firms that pay promptly.

Increase in inventories: The expected increase in sales requires additional investment in inventories.

Labor, administrative, and other expenses: This category includes all other regular business expenses.

Taxes, interest, and dividend payments: This includes dividend payments to stockholders and interest on currently outstanding long-term debt.

Answer 13:

Credit Management refers to the collection of revenues in respect of goods and services supplied. Ideally, the company would wish to collect their sales proceeds at the earliest but a balance needs to be struck. An excessively strict credit policy would adversely affect relations with Customers.

When one company sells goods to another, it does not usually expect to be paid immediately. These unpaid bills, or trade credit, compose the bulk of accounts receivable. The remainder is made up of consumer credit, that is, bills that are awaiting payment by the final customer.

Management of trade credit requires answers to five sets of questions:

1. How long are you going to give customers to pay their bills? Are you prepared to offer a cash discount for prompt payment?
2. Do you require some formal IOU from the buyer or do you just ask him or her to sign a receipt?
3. How do you determine which customers are likely to pay their bills?
4. How much credit are you prepared to extend to each customer? Do you play it safe by turning down any doubtful prospects? Or do you accept the risk of a few bad debts as part of the cost of building a large regular clientele?
5. How do you collect the money when it becomes due? What do you do about reluctant payers or deadbeats?

Answer 14:

Most firms keep inventories of raw materials, work in process, or finished goods awaiting sale and shipment. But they are not obliged to do so. For example, they could buy materials day by day, as needed. But then they would pay higher prices for ordering in small lots, and they would risk production delays if the materials were not delivered on time. They can avoid that risk by ordering more than the firm's immediate needs.

Similarly, firms could do away with inventories of finished goods by producing only what they expect to sell tomorrow. But this too could be a dangerous strategy. A small inventory of finished goods may mean shorter and more costly production runs, and it may not be sufficient to meet an unexpected increase in demand.

There are also costs to holding inventories that must be set against these benefits. Money tied up in inventories does not earn interest, storage and insurance must be paid for, and there may be risk of spoilage or obsolescence. Firms need to strike a sensible balance between the benefits of holding inventory and the costs.

Most firms do not use up their inventory of raw material at a constant rate, and they would not wait until stocks had completely run out before they were replenished. But this simple model does capture some essential features of inventory management:

- Optimal inventory levels involve a trade-off between carrying costs and order costs.
- Carrying costs include the cost of storing goods as well as the cost of capital tied up in inventory.
- A firm can manage its inventories by waiting until they reach some minimum level and then replenish them by ordering a predetermined quantity.
- When carrying costs are high and order costs are low, it makes sense to place more frequent orders and maintain lower levels of inventory.
- Inventory levels do not rise in direct proportion to sales. As sales increase, the optimal inventory level rises, but less than proportionately.

Answer 15:

Long-term planning involves capital budgeting on a grand scale. It focuses on the investment by each line of business and avoids getting bogged down in details. Of course, some individual projects may be large enough to have significant individual impact.

Normally, however, planners do not work on a project-by-project basis. Instead, they are content with rules of thumb that relate average levels of fixed and short-term assets to annual sales, and do not worry so much about seasonal variations in these relationships.

In such cases, the likelihood that accounts receivable may rise as sales peak in the holiday season would be a needless detail that would distract from more important strategic decisions.

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The development of financial plans involves:

Begin by consideration of an Organization's Business Plans:

- Anticipated Product development and Sales objectives
- Organic Development of existing activities and plans for new developments (whether expansion or retrenchment)
- Sensitivity Analysis to begin at this stage, by exploring various business plans under a range of scenarios

Secondly, business plans are converted into Financial Plans:

- Forecasting of Future Cash Flows
- Analyzing the anticipated need for working capital and growth in fixed assets, together with considerations of tax, dividends and interest payments
- Plan for Capital Budgeting and Capital Structure
- Sensitivity Analysis will be needed to allow for possible changes in the financial environment

Answer 16:

1. The primary objective is to maximize shareholders' wealth and overall return on their investment within the external constraints. This in turn will more often than not lead to profit maximization by achieving optimal profit, both in the short and long run. [1]
2. As a financial manager, I will be responsible for the financial health of the company and will take major investment and financing decisions I will decide not only which assets their firm should invest in but also where those assets should be located. [1]
3. In order to achieve the objectives, I will also look after cash management, raising capital, banking relationships, preparation of financial statements, handling accounting and taxation, preparing financial policy, etc. [1]
4. In order to maximize the return to the owners of equity, I will have to pay special attention to the points mentioned below:
 1. The variability of anticipated returns having regard to the nature of the business. [½]
 2. The degree to which risk should be carried by the owners. [½]
 3. The owners' desire for immediate profit rather than future high growth. [½]
 4. The willingness of the owners to put additional capital into the business. [½]
 5. The owner's willingness to see a reduction in the proportion of the business which they own. [½]

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- A. The merger between RDJ Properties Ltd. and Strange Properties Ltd is a horizontal merger. A horizontal merger is a merger between companies that directly compete with each other. [1]

The other types of mergers that Peter Group can enter into are as below:

1. Vertical Merger

A vertical merger is a merger between companies that operate along the supply chain. Therefore, in contrast to a horizontal merger, a vertical merger is the combination of companies along the production and distribution process of a business. [1]

2. Conglomerate Mergers

A conglomerate merger is a merger between companies that are totally unrelated. A **Pure Conglomerate Merger** involves companies that are totally unrelated and that operate in distinct markets. A **Mixed Conglomerate Merger** involves companies that are looking to expand product lines or target markets. [2]

The biggest risk if one of the member companies of Peter Group enters into a merger with Moon Pharma is the immediate shift in business operations resulting from the merger, as Moon Pharma operates in completely different markets and offer products/services unrelated to those of member companies of Peter Group. [1]

- B. The other motives for merger are as below:

1. Shareholder Gains

By shareholders gains refers to the increase in the market value of the firm due to the merger. Since the increase in the value of the firm directly benefits its owners (shareholders) it is said that shareholders gain. A firm may increase its market value by increasing its profits. Increasing profits, in turn, is possible by decreasing costs, operating more efficiently, implementing optimal incentives to managers or enhancing market power. [1]

2. Synergies

This is the most common reason for a merger. It is expected that when two companies merge to form a new bigger company, the value of the new entity will be more than the combined value of two separate companies. Cost Synergies reduce costs through the economies of scale in various divisions of the company, viz. research and development, procurement, sales and marketing, manufacturing, distribution and general administration. Revenue Synergies increase the overall revenue through expanded markets, products cross-selling and an increase in prices. [1]

3. Tax Advantages

In many countries, the acquiring company will be able to deduct past losses of the target company from the consolidated taxable income. To decrease the attractiveness of this motive, some countries limit the amount of tax loss carry-forward that can be deducted annually from the taxable income. [1]

4. Protection against a hostile takeover

Defensive acquisition is one of the hostile takeover defense strategies that may be undertaken by target of the hostile takeover to make itself less attractive to the acquiring company. In such a situation, the target company will acquire another company as a defensive acquisition and finance such an acquisition through adding substantial debt. Due to the increased debt of the

target company, the acquiring company, which planned the hostile takeover, will likely lose interest in acquiring the now highly leveraged target company. [1]

5. Rapid Growth

Mergers and acquisitions help companies to grow externally, especially the ones in a mature industry as the industry offers limited opportunities for growth. It is less risky to have external growth. [1]

6. Unique Capabilities

Not every company can have all the resources or strengths required for a successful growth. There will come a time when the company wants to acquire the competencies and resources that it lacks. This can easily be done through mergers and acquisitions in a very cost-effective way as compared to developing the capabilities internally. [1]

7. Gaining access to funds

The acquiring company may have high financial leverage (a lot of debt) thereby making access to additional external debt financing very limited. Therefore, one of the motives of the acquiring company to undertake the merger is to merge with a company which has a healthy liquidity position with low or non-existent financial leverage (very little or no debt). [1]

8. Economies of vertical integration

Economies of vertical integration are revealed when the sum of the cost of separately owned stages of production falls when a single firm performs the two stages of production. These cost savings can be localized in the technical relationship between the two stages of production or in the market transactions costs (distribution costs). [1]

[1 mark each for any other valid point – Max. 7 marks]

C. The potential problems with merger are as below:

1. Clash of Corporate culture

It might turn out that there are cultural differences with Strange Properties Ltd. which might lead to failure of merger. [1]

2. Increased business complexity

The increased products and operations after merger with Moon Pharma can be difficult to manage. [1]

3. Employees may be resistant to change

The employees may have to undergo training and relocation which they might be resistant to. They might fail to understand the need to undergo change due to lack of proper communication. [1]

4. Legal Constraints

There can be a lot of legal obstacles during the completion of a merger. This is generally considered to be an area of concern.