

Class: MSc

Subject : Business Finance

Chapter: Unit 2 Chapter 3

Chapter Name: Mergers and Divestitures

Today's Agenda

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1 Introduction

Many businesses believe that they need to grow in order to provide a better return for shareholders, which is often vital for a company's survival. If a business fails to grow, this may benefit its more aggressive rivals and they may secure a greater share of the market.

The main motives for growth are:

1. Increased profitability
2. Increased security
3. Increased motivation for managers and employees

1.1 Relationship between profit and growth

Profits fund a large proportion of new investment so, in order to grow, the company needs profits. Even if the company is able to obtain some long-term finance, it will probably have to finance some of its growth by ploughing back some of its profits (ie retaining profit rather than distributing it as dividends to the shareholders). However, undertaking a growth strategy can be very expensive for the company. In the short term, as well as the investment in plant and equipment, there will be additional expenses, such as advertising and training costs, which could reduce annual profit. In the longer run, as the new investment brings results in the form of higher revenue and lower costs, annual profit should increase.

1.2 Constraints on growth

The firm's plans for growth can be constrained for a number of reasons:

1. Difficulties in raising finance
2. Fears of a fall in the share price
3. Lack of managerial experience and expertise
4. Limited time to prepare the workforce including management
5. Government policy on monopoly power and mergers

1.3 Methods of achieving growth

There are many methods of achieving growth, but they can be divided into two main groups:

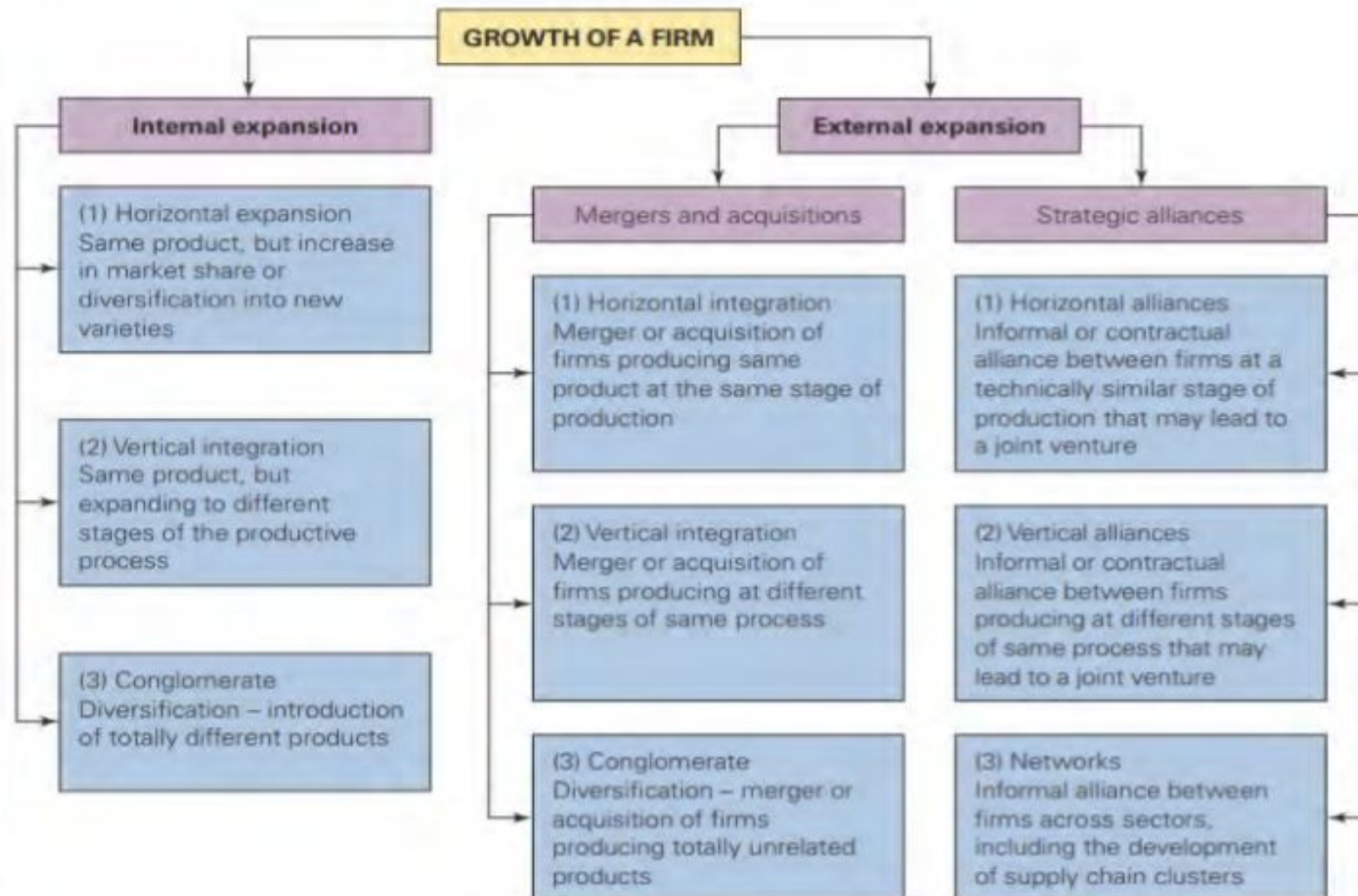
Internal (or organic) growth, ie expansion of its own operations

- retain control
- avoid the disruptive influence of alien business cultures or practices
- avoid the risk of dealing with firms that lack integrity
- avoid unnecessary government intervention.

External growth, ie integration with another firm or firms

- an easier and quicker method of growth, especially if the company wishes to expand geographically the opportunity to acquire assets or experience
- the opportunity to share the financial burden and the risk of a project
- the opportunity of a good use of spare cash for a mature company.

1.3 Methods of achieving growth



2 Mergers & Acquisitions



A merger occurs when two or more firms agree to combine their business operations into a new legal entity with a new name. It does not necessarily require any finance; and managers from both teams are usually employed in the new business.



An acquisition (or takeover) occurs when one firm (the acquirer) buys sufficient shares in another firm (the target) to take control of that firm. The acquiring firm needs finance in order to buy the shares of the target.

2.1 Types of mergers

Mergers can be horizontal, vertical, or conglomerate.

A **horizontal merger** is one that takes place between two firms in the same line of business.

Example: Facebook completed the acquisition of WhatsApp Messenger

A **vertical merger** involves companies at different stages of production. The buyer expands back toward the source of raw materials or forward in the direction of the ultimate consumer.

Example: AT&T's acquisition of Time Warner is an example.

A **conglomerate merger** involves companies in unrelated lines of businesses.

Example: the Indian Tata Group is a huge, widely diversified company. Its acquisitions have been as diverse as Eight O'Clock Coffee, Corus Steel, Jaguar Land Rover, the Ritz Carlton (Boston), and British Salt.

2.2 Methods of evaluating a target company

- SWOT(Strengths, Weaknesses, Opportunities, Threats) Analysis
- When evaluating a potential target company, an acquirer might consider the following headings:
 1. Resources
 2. Costs
 3. Market
 4. Security
 5. Compatibility
- The target should:
 1. meet its needs, eg be a reliable supplier
 2. offer the acquirer the potential to add value, eg by improving management, reorganising the structure, investing in new technology so that the value and performance of the two companies combined will be greater than the sum of the separate companies.
- Once a decision has been taken to engage in merger or acquisition activity, a proper assessment of the target company must be conducted.

2.2 Methods of evaluating a target company

- The acquirer would try to estimate the net gain to the acquirer's shareholders, ie the net present value (NPV) of the gains less the losses from the acquisition.
- Alternatively, the net gain to the acquirer's shareholders could be seen as the wealth with the acquisition less the wealth without the acquisition.

2.3 Steps taken in an acquisition

1. Check government policy and relevant regulations and legislation on acquisitions.
2. Obtain shareholders' approval for the purchase of the target's shares.
3. Arrange the raising of finance to purchase the target's shares. The funds could be raised by a rights issue or a new debt issue.
4. Determine the method of payment for the target firm's shares.
5. Approach the board of directors of the target company and make an offer.
6. If the takeover is friendly, discussions will take place, due diligence will be performed (ie investigations and checks of financial records, tax records and senior management etc), a definitive agreement on financial matters and non-financial matters (such as management structures) will be reached, and shareholders and regulators will be asked to approve.
7. In the case of a hostile takeover, the target's board of directors tries to prevent the takeover (possibly even taking action to make the target seem less attractive) so the acquirer either withdraws interest or must make a bid directly to the shareholders.

2.4 Is a merger successful?

Five major criteria will determine whether a merger is successful:

1. Is management successful in deal making? Experienced acquirers tend to do better than firms that make infrequent acquisitions.
2. Will the acquisition strengthen the buyer's core? Firms tend to do better when they acquire companies that operate in businesses they understand.
3. Did management do its homework? Successful acquirers take time to do the necessary due diligence.
4. Is the company addressing merger integration issues up front? Deals can often unravel because there is no clear plan for how the two management teams are going to be integrated after the acquisition.
5. Is the executive team prepared for the unexpected? History shows that nothing turns out the way it was planned. Successful acquirers anticipate the unexpected and are able to adapt well to changing circumstances.

2.4 Discuss



Do you know about any recent mergers?



<https://analyticsindiamag.com/top-tech-mergers-and-acquisitions-in-india-in-2022-so-far/>

3 **Leveraged buyouts**

A leveraged buyout (LBO) is different from an ordinary acquisition in two ways:

1. A large part of the funds required to purchase the company is raised by debt. The buyer, usually a private equity fund (or sometimes the company's management, in which case the acquisition is called a management buyout (MBO)), only puts up a small amount of money, borrowing the rest.
2. The LBO becomes a private company and ceases to trade on the open market.

3 Leveraged buyouts

The main motive for LBOs is profit. The profit might arise from:

1. selling off the assets that are not needed
2. the tax relief on debt finance
3. the installation of a new management team that reduces expenses and capital spending.

The main motive for MBOs is to improve efficiency and hence to save businesses and jobs.

As a result of a MBO, the new private company can become very successful, driven by the dual incentives of the personal self-interest of the new owners (managers) and the need to generate cash to pay debt interest

3 Leveraged buyouts

Target Company	Country	Indian Company	Value	Type
Tetley	United Kingdom	Tata Tea	?271 million	LBO
Whyte & Mackay	United Kingdom	UB Group	?550 million	LBO
Corus	United Kingdom	Tata Steel	\$11.3 billion	LBO
Hansen Transmissions	Netherlands	Suzlon Energy	465 million	LBO
American Axle	USA	Tata Motors	\$2 billion	LBO
Lombardini	Italy	Zoom Auto Ancillaries	\$225 million	LBO