Valuation for Acquisitions and Mergers 2

- Growth strategies
- Types of Mergers/Acquisitions
- Synergy Benefits
- Forms of payment
- Defences against takeover
- Reverse takeovers

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Growth Strategies

A company can use three strategies to achieve its growth objective:

1. Organic growth (Internal development)
2. Acquisitions / mergers
3. Joint ventures

Advantages of organic growth and disadvantages of growth by acquisition

- Organic growth permits an organisation to carefully plan its strategic growth in line with stated objectives. It is less risky than growth by acquisition, which occurs at one go.

- The cost is often much higher in an acquisition. As the bidding company usually has to pay a significant acquisition premium to acquire the target company.

- Post acquisition integration problems. The integration process is often a difficult process due to cultural differences between the two companies.

- An acquisition places an immediate pressure on current management resources to learn to manage the new business.

Disadvantages of organic growth and advantages of growth by acquisition

- If a company has chosen to enter a particular market, the quickest way is to purchase an established company in the product or geographical market.
- To eliminate competition and increase market power in order to be able to exercise some control over the price of the product.
- To acquire the target company's staff highly trained staff. To apply their talent, knowledge and techniques to the parent company's existing and future product lines to give them a competitive edge.
- Acquisition enables a company to quickly take advantage of a market opportunity.

Reasons for acquisitions and mergers

- Speed of implementing business plan
- Lower costs than organic growth
- Operating economies
- Acquisition of intangible assets/technology
- Acquisition of management team
- Diversification
- Asset backing
- Access to markets
- Earnings quality
- Enhanced cash resources

Types of Merger

Horizontal Integration: - This is when two businesses in the same line of business are combined.

Vertical Integration: - This is where business at a different level in the "chain of supply" combine.

Conglomerate Integration: - A combination of unrelated businesses.

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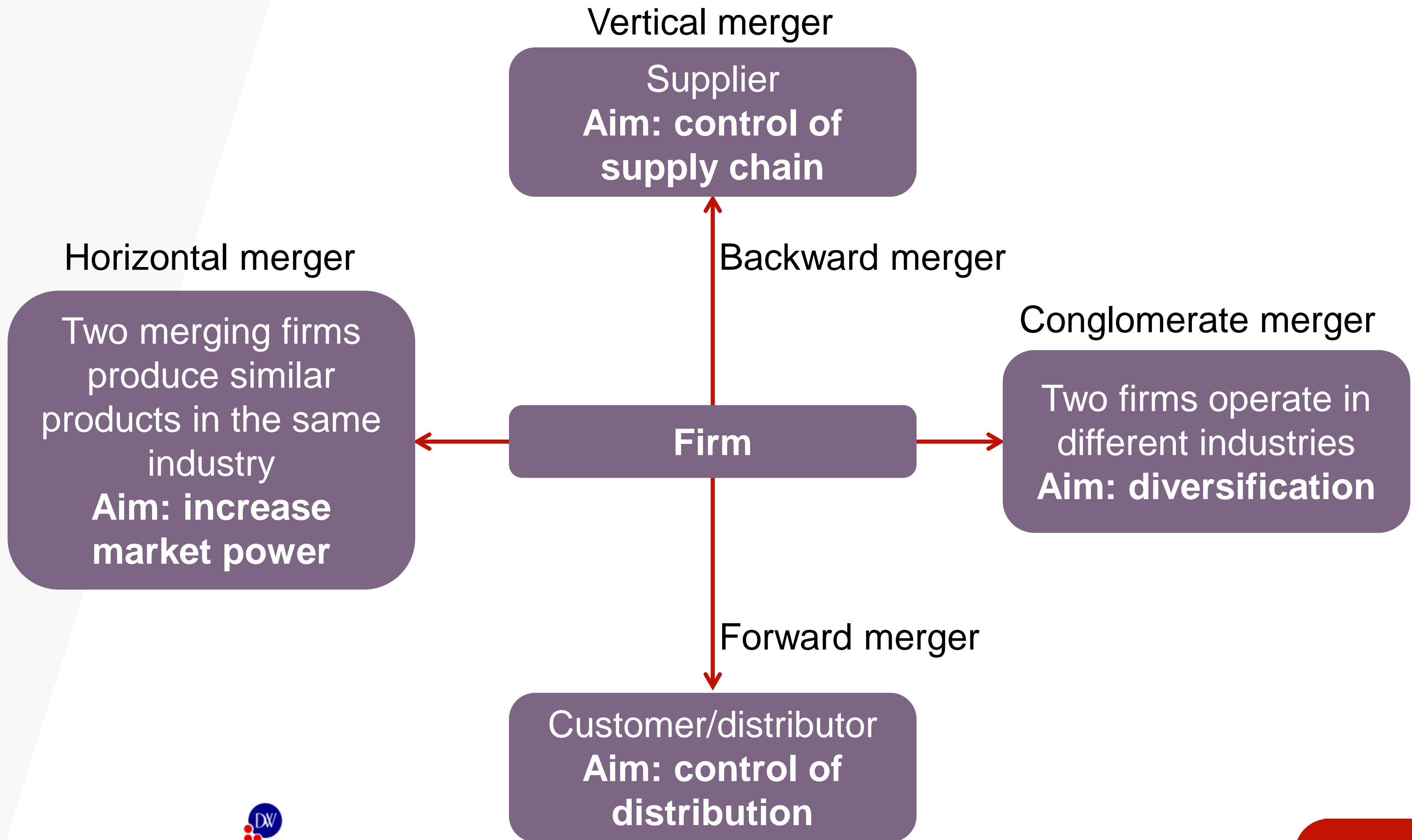
Types of merger



Synergies

Synergies

This refer to the extra benefits resulting from an acquisition either from higher cash inflows and or lower risk.

- Synergy represents additional value created post acquisition or merger
- Value is created when the total value of combined > (exceeds) the sum of their individual values pre-acquisition

Synergy Equation:

Synergy benefits = Total value of combined companies – (less) Total value of individual companies.

Calculating combined equity value– Free cash flow

Steps:

1. Calculate the group's new combined WACC.
2. Discount the combined post-acquisition free cash flows at this WACC to arrive at the combined firm value (Ve + Vd).
3. Subtract from firm value, the value of debt if provided to calculate the value of equity. If not provided use the post-acquisition gearing to find the proportion (value) for equity.

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Calculating the group's combined WACC

Steps:

1. Identify or calculate the asset beta of both companies.
2. Calculate the (combined) average asset beta for the group post-acquisition using their pre-acquisition equity values as weights.
3. Regear the combined asset beta using group new gearing post-acquisition.
4. Calculate cost of equity Ke using new equity beta (ie. regeared asset beta)
5. Calculate the group's new combined WACC using the Ke, the post-tax cost of borrowing and gearing ratio post-acquisition.

Calculating the combined WACC

Company X wants to acquire Company Y. The following financial information is provided for the two companies:

	X	Y
Current share price	$5.80	$2.40
Number of issued shares	210 million	200 million
Equity beta	1.2	1.2
Asset beta	0.9	1.2

The debt-to-equity ratio of the combined company will be 40:60 in market value terms and it is expected that the combined company's cost of debt will be 4·55%. The corporation tax rate is 20%, the current risk free rate of return is 2% and the market risk premium is 7%. It can be assumed that the combined company's asset beta is the weighted average of Company X and Company Y's asset betas, weighted by their current market values.

Calculate the combined post-acquisition weighted average cost of capital

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Calculating the combined WACC

Combined company, cost of capital

Asset beta

(1·2 x 480 + 0·9 x 1,218)/(480 + 1,218) = 0·985

Equity beta

0·985 x (60 + 40 x 0·8)/60 = 1·51

Cost of equity

2% + 1·51 x 7% = 12·57%

Cost of capital

12·57% x 0·6 + 4·55% x 0·8 x 0·4 = 9·00%

Calculating combined equity value– Free cash flow (1)

Company X wants to acquire Company Y. The following financial information is provided for the two companies:

	X	Y
Current share price	$5.80	$2.40
Number of issued shares	210 million	200 million
Equity beta	1.2	1.2
Asset beta	0.9	1.2

It is thought that combining the two companies will result in several benefits. Free cash flows to firm of the combined company will be $216 million in current value terms, but these will increase by an annual growth rate of 5% for the next four years, before reverting to an annual growth rate of 2·25% in perpetuity.

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Calculating combined equity value– Free cash flow (2)

In addition to this, combining the companies will result in cash synergy benefits of $20 million per year, for the next four years. These synergy benefits are not subject to any inflationary increase and no synergy benefits will occur after the fourth year. Assume a combined post-tax cost of capital of 9%.

Estimate the additional equity value created by combining Company X and Company Y based on the free cash flows to firm method

Calculating combined equity value– Free cash flow

Answer

Combined company equity value
Years 1 to 4 ($ millions)

Year	1	2	3	4
Free cash flows before synergy (growing at 5%)	226·80	238·14	250·05	262·55
Synergies	20·00	20·00	20·00	20·00
Free cash flows	246·80	258·14	270·05	282·55
PV of free cash flows at 9%	226·42	217·27	208·53	200·17

Total PV of cash flows (years 1 to 4) = $852·39 million
Total PV of cash flows (years 5 to perpetuity) = 262·55 x 1·0225 /(0·09 – 0·0225) x $1{\cdot}09^{-4}$ = $2,817·51 million

Total value to firm = $3,669·90 million

Value attributable to equity holders = $3,669·90 million x 0·6 = $2,201·94 million

Additional value created from the combined company = $2,201·94 million – ($1,218 million + $480 million) = $2,201·94 million – $1,698·00 million = $503·94 million (or 29·7%)

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Calculating combined equity value– P/E ratio

A listed **company A** is making a bid to purchase an unlisted **company B** operating in the biotechnology industry. Below are extracts of financial information for both companies

	A	B		
	20X3	20X3	20X2	20X1
	$m	$m	$m	$m
Pre-tax earnings	1980	397	370	352
Non- Current Assets	3965	882	838	801
Current Assets	960	210	208	198
Share capita ($0.25/share)	600	300	300	300
Reserves	2479	183	166	159
Non-current liabilities	1500	400	400	400
Current liabilities	354	209	180	140

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Calculating combined equity value– P/E ratio

It has been estimated that the unlisted **company B** should be valued at a factor of **1.1 times higher** than the biotechnology industry's P/E ratio. Currently the industry's average earnings per share is **50c and the average share price is $8.20.**

However, it is thought that the PE ratio of the combined company would **fall to 14·5** times after the acquisition. The annual after tax earnings will increase **by $140** million due to synergy benefits resulting from combining the two companies. Both companies pay **tax at 20%** per year and **company A's** current share price is **$9·24 per** share.

Company A is of the opinion that the premium should be assessed on synergy benefits created by the acquisition and the changes in value, due to the changes in the price-to-earnings (PE) ratio before and after the acquisition.

Calculate the maximum acquisition premium

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Calculating combined equity value– P/E ratio

Answer:

Industry P/E ratio	820/50 =	**16.4**
B's P/E ratio	16.4x 1.1 =	**18 times**
PAT of B	397x 0.8 =	317.6
PAT of A	1980 x 0.8 =	1584
Equity Value of B	317.6 x 18 times =	**$5716.8**
Equity Value of A	2400 shares x $9.24 =	**$22176**
Combined P/E ratio		14.5 times
Combined PAT + Synergy	(1584 +317.6 + 140) =	$2041.6
Total value of combined Equity	2041.6 x 14.5 times =	**$29603.2**

Maximum acquisition premium = Total value of combined companies – (less) Total value of individual companies.

Maximum acquisition premium =	(29603.2 - (22176 + 5729.5) =	**$1710.4**

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Factors in an acquisition

- Cost of acquisition
- Form of purchase consideration
- Reaction of target’s shareholders
- Reaction of acquirer’s shareholders
- Future policy (eg dividends, staff)
- Accounting implications

Methods of payment for acquisitions and mergers

Payment can be in the form of:

- Cash
- Share exchange
- Debt
- Often a combination of the above is used in order to give a choice to the target firm’s shareholders

The choice will depend on:

- Available cash
- Desired levels of gearing
- Shareholders' tax position
- Changes in control

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Choice of finance

Cash

Acquiring Company	Target Company
Advantages	Advantages
• The merger can be achieved quickly. • Shareholders retain control. • The consideration is likely to be cheaper as there is less risk to the shareholders.	• The value of the bid is known and the process is simple- this might persuade target's shareholders to sell.
Disadvantages	Disadvantages
• Cash flow strain • Increased gearing to raise cash, means increased financial risk, may increase cost of equity, hence a rise in WACC with a consequential fall in company value	• There might be tax implication that might influence the decision of shareholders—(liable to CGT immediately) • Shareholders would not participate in new group.

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Funding a cash offer

- **Retained earnings** – common when a firm acquires a smaller firm
- **Sale of assets**
- **Issue of shares**, using cash to buy target firm’s shares
- **Debt issue** – but issuing bonds will alert the market to the company’ s plans to bid for another company. Investors may buy shares of potential targets, raising their prices
- **Bank loan facility** – a possible short-term strategy, until bid is accepted: then the company can make a bond issue
- **Mezzanine finance** – may be the only route for companies without access to bond markets

Choice of finance

Share for share

Acquiring Company	Target Company
Advantages	Advantages
• No cash outflow and so may not increase financial risk by raising new debt. • Can take advantage of the bootstrapping opportunity if acquirer has higher P/E ratio.	• CGT tax liability is postponed • Shareholders would participate in new group
Disadvantages	Disadvantages
• Shareholders share future gains with the acquired company. • Dilution of control	• Uncertain value

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Choice of finance

Debt

Acquiring Company	Target Company
Advantages	Advantages
• When interest rates are low cost is low • Interest payment are tax deductible • Less dilution of EPS compared to share for share exchange.	• Guaranteed return and security of capital.
Disadvantages	Disadvantages
• Increase gearing hence increase risk	• Low rate of return - not popular with shareholders • No participation in new group. • Debt might be infrequently traded - affecting liquidity. • Lack of marketability might adversely affect its value.

Defences against a takeover

Where the Board feels that a takeover is not in their shareholders' best interests, it may decide to launch a defence against the bid

- Defences can take place **pre-offer** (use of weighted voting rights) or **post-offer** (selling major assets)
- Local legislation may make some of these defences illegal

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Defences against Takeover

Before the Bid

- Effective Communication with shareholders.
- Poison Pills
- Shark Repellent – Super majority clauses
- Revalue Asset
- Strategic Shareholdings / Cross Shareholdings

After the Bid

- Attack the Logic of the bid
- Rejection Letter
- Attacking the bidder
- White Knight
- Crown Jewels
- Competition Commission

Defences against a takeover

Golden parachutes

- Compensation payments made to eliminated top-management of target firm

Poison pill

- Attempt to make firm unattractive to takeover, eg by giving existing shareholders right to buy shares cheap

White knights

- Inviting a firm that would rescue the target from an unwanted bidder.

Defences against a takeover

Crown jewels

- Selling firm's valuable assets or arranging sale and leaseback, to make firm less attractive as target

Pacman defence

- Mounting a counter-bid for the attacker

Litigation or regulatory defence

- Inviting investigation by regulatory authorities or Courts

Reverse Takeovers

- The term ‘**reverse takeover**’ describes a situation where a smaller **quoted** company (Company S) takes over a larger **unquoted** company (Company L) by a **share for share exchange**.

- To acquire Company L, a large number of Company S shares will have to be issued to Company L’s shareholders. This will mean that **Company L will hold the majority of shares and will therefore have control of the company**.

- The company will then often be renamed, and it is normal for the larger company (Company L) to impose its own name on the new entity.

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Reverse Takeovers

Advantages of an RTO relative to an IPO

1. **Speed** - An IPO can take a long time, typically between one and two years, because it involves preparing a prospectus and creating an interest among potential investors.
2. **Cost** - An IPO is an expensive process and can cost between 3% and 5% of the capital being raised due to involvement of various parties, such as investment banks, law firms, prospectus, marketing etc, an RTO will usually, cost less but not always.
3. **Availability** – in periods of economic downturn it is not easy to convince investors to support an IPO, whereas this does not seem to be the case with RTOs since it does not need external investors since it is not raising external finance initially.

Disadvantages of an RTO relative to an IPO

1. **Risk -** As a result of the lower level of scrutiny that is applied the 'shell' listed company being used in the reverse takeover may have hidden liabilities which may not be obvious at the outset. Proper and full due diligence is necessary before the process is started.
2. **Lack of expertise** - The senior management of an unlisted company may not have the expertise and/or understanding of the rules and regulations which a listed company needs to comply with. The involvement of external parties over longer periods provides management with some understanding of what is required of them in an IPO.
3. **Share price decrease** - The original shareholders of the listed company may want to sell their shares immediately after the reverse takeover process has taken place and this may affect the share price negatively.
4. **Difficulty in raising new finance in future** – the previously private company subsequently seeking to raise new finance after an RTO may find it difficult due to lack of publicity or lack of sufficient analyst coverage. It may not be well known by potential investors.