Valuation for Acquisitions and Mergers 3 + Corporate Reconstruction and Re-organisation

- Evaluating forms of payments
- Factors to consider in share for share bid
- Why mergers and acquisitions fail
- Directives protecting the interest of shareholders

DUKE WILLIAMS
Professional Education and Training

Calculating acquisition premium or percentage gain per share for the target company

Step1

- Calculate or estimate the current share price of the target company

$$\text{Premium} = \frac{(\text{Offer price per share} - \text{Current share price of target company})}{\text{Current share price of the target company}}$$

Post-merger valuations

Cash offer

$$\text{Premium} = \frac{(\text{Cash offer price per share} - \text{Current share price of target company})}{\text{Current share price of the target company}}$$

DUKE WILLIAMS
Professional Education and Training

Post-merger valuations

Share for share exchange

Steps

Step1: Estimate the combined market value using the synergy equation:

ie $MV_{A+B} = MV_A + MV_B + \text{Synergies}$

	$'000
Pre-acquisition market value of equity (Acquiring company)	X
Pre-acquisition market value of equity (Target company)	X
PV of expected Synergy post-tax	X
Combined market value	X

Step2: calculate the combined number of shares:

	No of shares
Acquirer's number of share	xx
Target company (old no of shares x terms of offer)	xx
Combined number of shares	xx

DUKE WILLIAMS
Professional Education and Training

Post-merger valuations

Share for share exchange

Step3: Estimate the post-acquisition share price of the combined company

$$\text{Post-acquisition share price} = \frac{\text{Combined market value}}{\text{Combined} - \text{number} - \text{of} - \text{shares}}$$

Step4: Estimate an equivalent of an old share of the target Co
= Post-acquisition share price x terms of share for share offer

$$\text{Premium} = \frac{(\text{Equivalent old share price} - \text{Current share price of target Co})}{\text{Current share price of the target Co}}$$

DUKE WILLIAMS
Professional Education and Training

Bond (Debt) for share exchange

Step1: Find or estimate the market value of the bond per unit

Step2: Calculate the effective share price:
= Market value of the bond per unit / offer of the number of share per bond

$$\text{Premium} = \frac{(\text{Effective share price} - \text{Current share price of target Co})}{\text{Current share price of the target Co}}$$

Question: Post-merger valuations

Pinto Co is a listed company producing office furniture which it sells around the world. It wants to acquire Tornton Co, an unlisted company producing high quality, luxury garden furniture. Pinto Co proposes to pay for the acquisition using one of the following three methods:

- **Method 1:** A cash offer of $5·00 per Tornton Co share; or
- **Method 2**: An offer of three of its shares for two of Tornton Co's shares; or
- **Method 3:** An offer of a 2% coupon bond in exchange for 16 Tornton Co's shares. The bond will be redeemed in three years at its par value of $100.

Extracts from the latest financial statements of both companies are as follows:

	Pinto Co	Tornton Co
	$'000	$'000
Profit before tax	6,190	780
Taxation	(1,240)	(155)
Profit after Tax	4,950	625
Non-current liabilities	9,700	873
Share capital (40c per share)	4,400	500

DUKE WILLIAMS
Professional Education and Training

Question: Post-merger valuations

Pinto Co's current share price is $3·60 per share and it has estimated that Tornton Co's price to earnings ratio is 12·5% higher than Pinto Co's current price to earnings ratio.

Pinto Co's non-current liabilities include a 6% bond redeemable in three years at par and has a yield to maturity of 4.6%

Pinto Co estimates that it could achieve synergy savings of 30% of Tornton Co's estimated equity value by eliminating duplicated administrative functions, selling excess non-current assets and through reducing the workforce numbers, if the acquisition were successful.

Required:
Estimate the percentage gain on a Tornton Co share under each of the above three payment methods.

Share-based bids

For a share for share exchange shareholders in both acquiring and target companies would be interested in.

- **S**ynergies identified
- The size of **A**cquisition Premium
- Similarities of differences in **D**ividend policies
- **G**earing
- How the **I**ntrinsic Values of shares compares with actual trading values
- **F**uture prospects in terms of growth in earnings
- **C**ontrol of the enlarged company.

EU Directives

Conditions aims to ensure that shareholders are related fairly and equitably.

Mandatory-bid conditions through sellout rights.

- This allows the remaining shareholders to exit the company at a fair price once the bidder has accumulated a certain percentage of shares. This percentage however differs from one country to another. The bidder must offer the highest share price as the minimum which has been paid by the bidder previously. This is to ensure that minority shareholders are not exploited.

The principle of equal treatment

- This principle stipulates that all shareholder groups must be offered the same terms and treated equally. This is to ensure that minority shareholders are offered same level of benefits as the previous shareholders form whom the controlling stake in the target company was obtained.

EU Directives

squeeze-out rights

- The rights allows the bidder to force minority shareholders to sell their stake at a fair price once The bidder has acquired a specific percentage of the target company's equity. This percentage varies from one country to the other ranging between 80% and 95%. The main purpose-of this condition is to enable the acquirer to pain 100% stake of the target company and present problems arising from minority shareholders in future.

DUKE WILLIAMS
Professional Education and Training

Why mergers and acquisitions fail

- There may be a good fit of products or services, but a serious **lack of fit** in terms of management styles or corporate structure.
- Lack of goal congruence
- Lack of knowledge of industry or target company
- Little or no experience of acquisitions
- Little or no post-acquisition planning
- Poor management and poor management practices in target company

Corporate Reconstruction and Re-organisation

- Types of Reconstruction
- Business re-organisation
- Forms of unbundling

DUKE WILLIAMS
Professional Education and Training

Types of reconstruction

- **Financial/capital reconstruction** – changing the capital structure of the firm
- **Portfolio reconstruction** – making additions to or disposals from companies' businesses, eg through acquisitions or spin-offs
- **Organisational restructuring** – changing the organisational structure of the firm

Business Re-organisations

Organisational restructuring involves changes in organisational structure of firm, such as changing divisional structure

Portfolio restructuring is acquisition or disposal of business units by a company

- **Unbundling** is portfolio restructuring strategy involving disposal and sale of assets, facilities, production lines, subsidiaries or product units

Reasons for unbundling

Motives	Explanation
Raising cash	Selling off allows cash to be raised to ease liquidity problems or to reduce gearing.
Disposal of non-core businesses	Acquired as a part of a group that has been taken over by the company or a consequence of a strategic review.
Take-over defence	Selling off underperforming divisions may deter a take-over bid that aims to add value by unbundling the company.
Synergy	Other owners may be able make better use of a division of the company, and will pay a high price for purchasing all or part of it.

Forms of unbundling

- Divestments
- Demegers
- Sell-offs
- Spin-offs
- Equity Carve-outs
- Management buy-outs and buy-ins

Forms of unbundling

Divestments

- Divestment through sell-off usually involves selling part of a company as an entity or as separate assets to a third party for an agreed sum on value. The value may comprise of cash and non-cash based assets. Funds from the sale may be used to develop other parts of business or used for the acquisitions.

Possible reasons

- the need to restructure a conglomerate so as to focus (concentrate on core competences.
- the need to sell unwanted assets.
- the need to respond / react to changes in the business environment.

Forms of unbundling

Demergers

- This involves the splitting a company into two or more parts, with each becoming a separate, independent company. The shareholders would then hold shares in each separate independent company. Each company would most probably have its own separate management team.

Forms of unbundling

Benefits of demergers

- The **different businesses** can follow **financial strategies more appropriate to their activities**
- The separate management teams will be able to **focus on creating value for each company separately**
- Leads to the removal of the "conglomerate discounters
- Leads to **greater market transparency** and greater understanding.
- Greater operational efficiency and the greater opportunity to realise value
- Diversification of **shareholder portfolio will remain unchanged**

Forms of unbundling

Disadvantages of demergers

- **Process may be expensive**
- **Economies of scale** may be **lost**
- **Smaller companies** will have **lower turnover**, profits and status than the group before the demerger
- **Higher overhead** costs as a percentage of turnover
- **Ability** to raise **extra finance**, especially debt finance, to support new investments and expansion may be reduced
- **Vulnerability to takeover** may be **increased**
- Impact on **firm's risk** may be significant, with a loss in shareholder value if low beta element is unbundled

Management buy-out (MBO)

This is the purchase of all or part of a business by its managers

- The managers generally need financial backers (venture capital) who will want an equity stake

Financial reconstructions

A **financial/capital reconstruction** scheme is a scheme where a company re-organises its capital structure. They include

- leveraged buyouts,
- leveraged recapitalisations and
- debt for equity swaps.

Reasons for financial reconstructions

- Save a company with debt problems
- Rearrange capital structure
- Write off large debit balances
- Reduce value of shares

Financial reconstructions

Leveraged buy-outs

- A group of private investors uses debt financing to purchase a company or part of it
- The company increases its level of leverage but no longer has access to equity markets

Financial reconstructions

Leveraged recapitalisation

- A firm replaces most of its equity with a package of debt securities consisting of both senior and subordinated debt
- Used to discourage corporate raiders not able to borrow against assets of the target firm to finance the acquisition
- To avoid financial distress from a high debt level, the company should have stable cash flows
- Company should not require substantial ongoing capital expenditure to retain their competitive position

Debt-equity swaps

- In an **equity-debt swap**, shareholders are given the right to exchange stock for a predetermined amount of debt
- In a **debt-equity swap**, debt is exchanged for a predetermined amount of stock
- After the swap takes place, the preceding asset class is cancelled for the newly acquired asset class

Debt-equity swaps

- Debt-equity swaps may occur because the company must meet certain **contractual obligations**
- A typical example is maintaining a debt/equity ratio below a certain number
- A company may issue equity to avoid making coupon and face value payments in the future

Financial reconstructions

Steps in a reconstruction

1. Estimate the position of each party if liquidation is to go ahead. This will represent the minimum acceptable payment for each group.
2. Assess additional sources of finance. For eg of selling assets, issuing shares or raising loans.
3. Design the reconstruction. Often the question will provide details on how to do this.
4. Calculate and assess the new position and how each group has fared and compare for each party with step 1.
5. Check that the company is financially viable after reconstruction.
6. Draw a conclusion about the proposed scheme on the basis of your analysis and put forward your justification argument.

Financial reconstructions

Scheme is likely to be successful if it ensures that:

- No group is worst off under the scheme than they would be under liquidation.
- There is a good chance that the company will be financially viable and profitable.
- All parties are treated fairly and
- The scheme raises adequate finance.

Question: Corporate Reconstruction

A company has two manufacturing divisions: parts and fridges. Although the parts division is profitable, the fridges division is not, and as a result its share price has declined to $0.50 per share from a high of $2.83 per share around three years ago. Assume it is now 1 January 2013.

The Board of Directors has arranged for a meeting to discuss how to proceed and is considering each of the following proposals:

- To cease trading and close down the company entirely.
- To undertake corporate restructuring in order to reduce the level of debt and obtain the additional capital investment required to continue current operations.

Cease trading:

If the entire company's assets are sold, the estimated realisable values of assets are as follows:

	$m
Non-current assets	100
Current assets	110

Question: Corporate Reconstruction

The following additional information has been provided

Redundancy and other costs will be approximately $54 million if the whole company is closed, and pro rata for individual divisions that are closed. These costs have priority for payment before any other liabilities in case of closure. The taxation effects relating to this may be ignored. All liabilities categories have equal claim for repayment against the company's assets.

Corporate restructuring:

The existing ordinary shares will be cancelled and ordinary shareholders will be issued with 40 million new $1 ordinary shares in exchange for a cash payment at par. The existing unsecured bonds will be cancelled and replaced with 270 million of $1 ordinary shares. The bond holders will contribute $90 million in cash. All the shares will be listed and traded. The bank overdraft will be converted into a secured ten-year loan with a fixed annual interest rate of 7%. The other unsecured loans will be repaid. An additional one-off capital investment of $80 million in machinery and equipment is necessary to increase sales revenue for both divisions by 7%, with no change to the costs. After the one-off 7% growth, sales will continue at the new level for the foreseeable future.

Question: Corporate Reconstruction

Extracts from the most recent financial statements:
Financial Position as at 31 December 2012

	$m
Assets	
Non-Current Assets	
Land and buildings	70
Machinery and equipment	50
	120
Current Assets	
Inventory	180
Receivables	40
	220
Total Assets	340
Equity and Liabilities	
Share capital (40c per share par value)	40
Reserves	20
	60
Non-Current Liabilities	
7% Unsecured bonds 2020	120
Other unsecured loans (currently $5^{1}/_{3}$% interest)	30
	150
Current Liabilities	
Payables	70
Bank overdraft (currently 10% interest)	60
	130
Total Liabilities and capital	340

Question: Corporate Reconstruction

Income Statement for the year ended 31 December 2012		$m
Sales revenue:	Parts division	170
	Fridges division	340
Costs prior to depreciation, interest payments and tax:	Parts division	(120)
	Fridges division	(370)
Depreciation, tax and interest		(34)
Loss		(14)

DUKE WILLIAMS
Professional Education and Training

Question: Corporate Reconstruction

Corporation tax on profits is 20% and it can be assumed that tax is payable in the year incurred. Annual depreciation on non-current assets including land and buildings is 15% and this is the amount of investment needed to maintain the current level of activity. It is expected that the company's cost of capital rate will reduce to 650 basis points following the restructuring from the current rate.

Required:

- Estimate the return the liability holders and the shareholders would receive in the event that company is closed and all its assets sold.
- Prepare a forecast of the statement of Financial Position of the company after the proposed restructuring
- Prepare an estimate of the income position and the value of the company in the event that the restructuring proposal is selected. State any assumptions made.