INTRODUCTION TO MERGERS AND ACQUISITIONS

Timeframe:	16 Hours
Learning Outcomes:	• Understand and explain the concept of subsidiaries and distinguish the different types • Distinguish green-field venture strategies from acquisitions • Discriminate between mergers and acquisitions • Assess the value of synergy in a potential merger and acquisition.
Recommended reading:	• Hill, R.A. 2012, *Company Valuation and Takeover: Part II* [e-book], Robert Allan Hill & Ventus Publishing ApS, http://buitemsce.files.wordpress.com/2012/08/company-valuation-and-takeover.pdf (accessed 25 September 2012). • Koch, T.W. and Macdonald, S.S. 2003, *Bank Management*, 5th edition, Mason, OH: Thomson Learning. • Lee, K. and Pennings, J. 2000, *Mergers and Acquisitions: Strategic organisational Fit and Outcomes*, Philadelphia: University of Pennsylvania. • Morck, R., Shleifer, A. and Vishny, R.W. 1988, 'Characteristics of Targets of Hostile and Friendly Takeovers', in Auerbach, A.J., (ed.) *Corporate Takeovers: Causes and Consequences*, University of Chicago Press. http://www.nber.org/chapters/c2054.pdf (accessed 20 August 2013). • Sudarsanam, S. 2010, *Creating Value from Mergers and Acquisition*, 2nd edition, India: Pearson Education India.
Section overview	This section will allow students to develop an understanding of the various concepts used in mergers and acquisitions. It forms the basis of students' knowledge required to understand the sections to follow.

Introduction to Mergers and Acquisitions

Mergers, acquisitions and take-overs occur in the world's corporate financial sector. As the various definitions will reveal, Mergers and Acquisitions (M&A) bring separate companies together to form one large company. Wall Street investment bankers play a huge role in creating one large company out of smaller ones. They are also responsible for corporate finance deals whose sphere involves breaking up companies through spin-offs, carve-outs and trading of stock (the opposite of M&A).

Mergers and acquisitions have become a topical issue because many multi-million dollar deals have not always yielded expected returns. The complex environment in which M&As occur often contributes to undermining the financial forecasts generated to predict the success of merged and acquired companies.

There are various ways and means to obtain alliances with different companies (related and unrelated). This section of the guide provides a discussion of subsidiaries, mergers, acquisitions, green-field investments and brown-field investments.

We will begin this discussion by explaining fundamental concepts that will serve as foundational knowledge for this study guide.

Introduction to Subsidiaries

Investopedia (2012f) defines a subsidiary as:

A company that is more than 50%-owned by another company. Mergers, acquisitions, green-field and brown-field investments are all types of subsidiaries.

A company that owns a subsidiary is referred to as the parent or holding company. The parent or holding company has full control over the subsidiary concerning functions such as operations, national concerns, and financial decisions (Investopedia, 2012f).

The Philosophy of Mergers and Acquisitions

M&A is built on the philosophy that one plus one equals three (1+1=3); in other words, the value of two companies combined is greater than the value of them apart and M&A is therefore thought to create additional value.

This principle is referred to as synergy and is one of the major reasons why company's are merged and acquire other companies.

Investopedia (2012g) defines synergy as 'The value of the two companies combined.'

To fully understand the nature of synergy, knowledge of valuations is required. Valuations will be discussed later in this.

It is important to understand ALL the reasons behind a company's decision to merge or acquire another.

Why Merge or Acquire a Company?

Various authors have differing views regarding the motives behind M&A.

Trautwein (1990:18) and Gaughan (2002:19) provide a systematic summary of the motives based on different theories (please refer to **Table 1** for clarity).

Trautwein (1990:18) affirms that merger and acquisition decisions are often motivated by synergy and valuation. This means that the outcome of combining two companies must have a positive net present value.

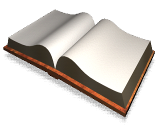
Gaughan (2002:19) takes a more pragmatic view than Trautwein. Although Gaughan relies on theory to some extent, his identification of M&A motives is always heavily supported by multiple empirical case studies.

According to Gaughan (2002:19), there are the four main motives:

- Organisational growth;
- Economic gains in the form of economies of scale;
- A greater share of the capital market which will ultimately lead to financial benefits; and
- Anticipated gains through the application of advanced management skills directed to the target's business.

Both authors agree that the motives behind M&A cannot be acquired by targeting a single theory or approach. Various reasons exist and each is unique and subjective.

An excellent article identified to assist you in your understanding of the reason behind mergers and acquisitions is:



- Lee, K. and Pennings, J. 2000, *Mergers and Acquisitions: Strategic organisational Fit and Outcomes*, Philadelphia: University of Pennsylvania.

TABLE 1: MERGER AND ACQUISITION MOTIVES

MOTIVE			THEORY	DESCRIPTION
M&A as rational choice	M&A benefits bidders shareholders	Net gains through synergy	Efficiency Theory	M&A is planned and executed to achieve synergies of three types: financial, operational and managerial.
		Wealth transfers from customers	Monopoly Theory	M&A is planned and executed to achieve market power. Horizontal and conglomerate M&A may allow firms to cross-subsidise products, limit competition in more than one market simultaneously, and deter potential entrants from the markets, all of which result in higher market power.
		Wealth transfers from target's shareholders	Raider Theory	A raider is a person who causes wealth transfers from the stockholders of the companies he bids for in the form of greenmail or excessive compensation after a successful takeover.
		Net gains through private information	Valuation Theory/ Investment Theory	M&A is planned and executed by managers who have better information about the target's value than the stock market.
	M&A benefits managers		Empire-Building Theory/ Agency Theory	M&A is planned and executed by managers who thereby maximise their own utility instead of shareholders' value.
M&A as process outcome			Process Theory	M&A decisions are outcomes of processes governed by one or more of the following influences: organisational routines, political games played between an organisation's sub-units and outsiders, and individuals' limited information-processing capabilities.
M&A as macroeconomic phenomenon			Disturbance Theory	M&A waves are caused by economic disturbances: Economic disturbances cause changes in individual expectations and increase in the general level of uncertainty, thereby changing the ordering of individual expectations. Previous non-owners of assets now place a higher value on these assets than on their owners and vice versa. The result is a M&A wave.

(Adapted from Trautwein, 1990 and Cox, 2006:20)

Types of Mergers

Mergers are characterised according to the relationship between the two concerned companies. The different types of mergers are explained in **Table 2**.

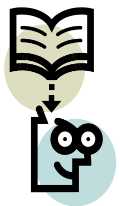
TABLE 2: TYPES OF MERGERS

Horizontal merger	These mergers typify industries and markets whose products are in the mature of declining stage of the product life-cycle. Two companies that are in direct competition and share the same product lines and markets are merged.
Vertical merger	A customer and a company or a supplier and a company are merged. Think of a cone supplier merging with an ice-cream maker. There is more control over input quality and delivery.
Market-extension merger	Two companies that sell the same products in different markets are merged.
Product-extension merger	Two companies selling different but related products in the same market are merged.
Conglomeration	Two companies that have no common business areas are merged.

(Adapted from Sudarsanam, 2010 and Investopedia, 2010)

Mergers are also classified according to how they are financed. This impacts the companies involved and investors.	
Purchase Mergers	Purchase mergers occur when a parent or holding company purchases another company. The purchase has the following characteristics: • It is purchased with cash or a debt instrument; • It is taxable. Due to the tax benefit that this method generates, it is favoured by acquiring companies.
Consolidation Mergers	Consolidation mergers are characterised by a new company being formed. The companies that have decided to merge will loose their identity and a new entity will be formed.

(Linton, 2014)



Find a local and international example for each type of merger. Evaluate the success of these mergers.