An Overview on Merger and Acquisitions

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Abstract

Merger and acquisitions (M&A) have become a major force in the financial and economic environment allover the world. In India because of the liberalization of FERA (Foreign Exchange Regulation Act), MRTP (Monopolies and Restrictive Trade Practices)Act , industrial licensing and the compulsion to be more competitive, corporates are looking seriously at mergers and acquisition. Merger can be defined as a process, which involves a transaction that combines two firms into one new firm. An acquisition is the purchase of one firm by another firm. This paper tries to find out different aspects of merger and acquisitions , such as different types of M &A ,history of M &A, its objective and also the pitfalls.

Introduction

In a rapidly changing world, companies are facing unprecedented turmoil in global markets . Severe competition , rapid technological change, and rising stock market volatility have increased the burden on managers to deliver superior performance and value for their shareholders . In response to these pressures, an increasing number of companies around the world are dramatically restructuring their assets, operations, and contractual relationships with shareholders, creditors and other financial stakeholders. Corporate restructuring has facilitated thousands of organizations to reestablish their competitive advantage and respond more quickly and effectively to new opportunities and unexpected challenges . Corporate restructuring has had an equally profound impact on the many more thousands of suppliers, customers, and competitors that do business with restructured firms .

Generally, most of the corporate growth occurs by internal expansion, when a firm's existing division grow through normal capital budgeting activities. Nevertheless, if the goals are easily achieved within the firm, it may mean that the goals are too small . Growth opportunities come in a variety of other forms and a great deal of energy and resources may be wasted if an entrepreneur does not wait long enough

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to identify the various dynamics which are already in place . The most remarkable examples of growth and often the largest increases in stock prices are a result of mergers and acquisitions . M &A offer tremendous opportunities for companies to grow and add value to shareholders' wealth . M&A is a strategy for growth and expansion . M&A generic term used to represent many different types of corporate restructuring exercises .

Merger and acquisition deals are now at an all-time high, having doubled in frequency since 1990. Mergers and acquisitions refers to the aspect of corporate strategy, corporate finance and management dealing with the buying, selling and combining of different companies that can aid, finance, or help a growing company in a given industry grow rapidly without having to create another business entity.

An acquisition may be friendly or hostile. Whether a purchase is perceived as a friendly or hostile depends on how it is communicated to and received by the target company's board of directors, employees and shareholders. In case of a friendly transaction, the companies cooperate in negotiations, in case of a hostile deal, the takeover target is unwilling to be bought or the target's board has no prior knowledge of the offer. Hostile acquisitions can, and often do, turn friendly at the end, as the acquiror secures the endorsement of the transaction from the board of the acquiree company. This usually requires an improvement in the terms of the offer. Acquisition usually refers to a purchase of a smaller firm by a larger one. Sometimes, however, a smaller firm will acquire management control of a larger or longer established company and keep its name for the combined entity. This is known as a reverse takeover. The acquisition process is very complex, with many dimensions influencing its outcome. There is also a variety of structures used in securing control over the assets of a company, which have different tax and regulatory implications. The buyer buys the shares, and therefore control, of the target company being purchased. Ownership control of the company in turn conveys effective control over the assets of the company, but since the company is acquired intact as a going concern, this form of transaction carries with it all of the liabilities accrued by that business over its past and all of the risks that company faces in its commercial environment.

The buyer buys the assets of the target company. The cash, that the target company receives from the sell-off is paid back to its shareholders by dividend or through liquidation. This type of transaction leaves the target company as an empty shell, if the buyer buys out the entire assets. Merger & Acquisitions have become a major force in the financial and economic environment allover the world . On the Indian scene , thanks to the lib realization of FERA, MRTP Act and industrial licensing and the compulsion to be more competitive, corporates are looking seriously at mergers and acquisitions .

Forms of Corporate Restructuring

Business firms in their pursuit of growth, engage in a broad range of restructuring activities. Actions taken to expand or contract a firm's basic operations or fundamentally change its asset or financial structure are referred to as corporate restructuring activities .Corporate restructuring is a broad umbrella that covers many things . One of them is the merger or takeover . From the viewpoint of the buyer, M & A represent expansion and from the perspective of the seller it represents a change in ownership that may or may not be voluntary . In addition to mergers, takeovers, and contests for corporate control ; there are other types of corporate restructuring like divestitures, rearrangements and ownership reformulation .These corporate restructuring activities can be divided into two broad categories-operational and functional . Operational

restructuring refers to outright or partial purchase or sale of companies or product lines or downsizing by closing unprofitable, non-strategic facilities. Financial restructuring refers to the action taken by the firm to change its total debt and equity structure .

Overview of restructuring activities

Expansion – merger and acquisition, tender offers, asset acquisition

Contraction- Spin offs ,split offs ,divestitures, equity carve outs, assets sale

Corporate control – anti takeover defenses, share repurchases , exchange offers , proxy contests

Changes in ownership structures- leveraged buyout , junk bonds, going private, ESOPs (employee stock option plan)and MLPs(master limited partnership)

Expansion

Expansion is a form of restructuring, which results in an increase in the size of the firm . It can take place in the form of a merger , acquisition, tender offer or a joint venture .

Merger

Merger is defined as a combination of two or more companies into a single company. A merger can take place either as an amalgamation or absorption

Amalgamation

This type of merger involves fusion of two or more companies. After the merger the two companies lose their individual identify and a new company comes into existence . A new firm that is hitherto, not in existence comes into being . This form is generally applied to combinations of firms of equal size .

Example : The merger of Brooke Bond India Ltd with Lipton India Ltd resulted in the formation of a new company Brooke Bond Lipton India Ltd .

Absorption

This type of merger involves fusion of a small company with a large company . After the merger the smaller company ceases to exist .

Example : The merger of HDFC Bank and Times Bank . After the merger, Times Bank ceased to exist while the expanded HDFC Bank continued .

Merger Waves

United State has witnessed five periods of merger activity, often referred to as merger waves, each wave having been dominated by a particular type of merger. These periods were characterized by high level of cyclic activity, that is, high levels of mergers followed by periods of relatively fewer mergers . All the merger movements occurred when the economy experienced sustained high growth rates and coincided with particular developments in business environments, because firms are motivated to make large investment outlays only when the business prospects are favorable. When such favorable business prospects are joined with changes in competitive conditions directly motivating a new business strategy, M & A activity will be stimulated .

Types of Mergers

Merger or acquisition depends upon the purpose for which the target company is acquired . A company will seek to acquire the other company only when it has arrived at its own developmental plan to expand its operations after a thorough analysis of its own internal strength . It has to aim

at a suitable combination where it could have opportunities to supplement its funds; secure additional financial facilities, eliminate competition and strengthen its market position . Based on the reason why firms combine, mergers can be divided into three categories : (i) Horizontal mergers, (ii) Vertical mergers, and (iii) Conglomerate mergers .

Horizontal Mergers

A horizontal merger involves a merger between two firms operating and competing in the same kind of business activity . The main purpose of such mergers is to obtain economies of scale of production . The economies of scale is obtained by the elimination of duplication of facilities and operations and broadening the product line reduction in investment in working capital, elimination of competition in a product, reduction in advertising costs, increase in market share, exercise of better control on market, etc.)

(The alliance between Birla, AT & T and Tata (BATATA) in the Indian telecom Sector is an example of a horizontal merger .)

Vertical Mergers

A vertical merger involves merger between firms that are in different stages of production or value chain . They are combination of companies that usually have buyer-seller relationships . A company involved in a vertical merger usually seeks to merge with another company or would like to take over another company mainly to expand its operations by backward or forward integration . The acquiring company through merger of another unit attempts to reduce inventories of raw material and finished goods implements its production plans as per objectives and economizes on company would be either a supplier or a buyer using its product as an intermediary material for final production .

Examples : Nirma's bid for Gujarat Heavy Chemical (backward integration) or Hindalco bidding for Pennar Aluminium (forward integration) .

Conglomerate Mergers

Conglomerate mergers involve merger between firms engaged in unrelated types of business activity . The basic purpose of such combination is utilization of financial resources . Such type of merger enhances the overall stability of the acquirer company and creates balance in the company's total portfolio of diverse products and production processes and thereby reduces the risk of instability in the firm's cash flows.

Merger and Acquisitions Process

The acquisition process can be divided into a planning stage and an implementation stage . The planning stage consists of the development of the business and the acquisitions plans . The implementation stage consists of the search, screening, contacting the target, negotiation, integration and the evaluation activities. In short, the process of acquisition can be summarized in the following steps:

-Develop a strategic plan for the business (Business Plan)

-Develop an acquisition plan related to the strategic plan (Acquisition plan) .

-Search candidates for acquisitions (Search Process)

-Screen and prioritize potential candidates (Screening Process).

-Initiate contact with the target (First contact).

-Refine valuation, structure the deal, perform due diligence, and develop financing plan (Negotiation).

-Develop plan for integrating the acquired business (Integration plan)

-Obtain all the necessary approvals, resolve post-closing issues and implement closing (Closing)

-Implement post closing integration (Integration)

-Conduct the post closing evaluation of acquisition (Evaluation) .

History of M & A

M & A activity has increased substantially since the mid 1960's. In 1967, the total dollar value of the corporate merger & acquisition was under $20 billion, by 1984 this grew to a total dollar volume of $100 billion and by 1998 the dollar volume exceeded one trillion . The mega merger" is all very recent . The second thing to note is that there are all horizontal mergers, involving firm in the same industry .In the past few years there have been a large number of blockbuster mergers and acquisition that made the past M & A look small by comparison . For e.g. , the merger between Citigroup and Traveler's group estimated at $ 77 billion in value and EXXON's acquisition of Mobil for $ 81,429.8 millions . The size and number of merger and acquisition transactions continue to grow worldwide .The role of mergers and acquisitions had evolved as a strategy tool for fast- track technology-led companies. In current rapidly changing environment and in the era of systemic innovation, where technology is embedded in people and processes, well-planned M & A are recognized as critical to fast track technology company success and even survival.

Top 10 M&A deals worldwide by value (in mil. USD) from 2000 to 2009

Rank	Year	Purchaser	Purchased	Transaction value (in mil. USD)
1	2000	*Fusion*: America Online Inc. (AOL)	Time Warner	164,747
2	2000	Glaxo Wellcome Plc.	SmithKline Beecham Plc.	75,961
3	2004	Royal Dutch Petroleum Co.	Shell Transport & Trading Co	74,559
4	2006	AT&T Inc.	BellSouth Corporation	72,671
5	2001	Comcast Corporation	AT&T Broadband & Internet Svcs	72,041
6	2009	Pfizer Inc.	Wyeth	68,000
7	2000	Nortel Networks Corporation		59,974
8	2002	Pfizer Inc.	Pharmacia Corporation	59,515
9	2004	JP Morgan Chase & Co	Bank One Corp	58,761
10	2008	Inbev Inc.	Anheuser-Busch Companies, Inc	52,000

The Five Rules of Successful Acquisition : By Peter F. Drucker

- Think what you can contribute to the business it is buying , not what the acquirer company will contribute to the acquirer .
- Common core of unity : The two businesses must have a common either markets or technology .
- Temperamental fit : No acquisition work unless people in the acquiring company respect the product, the markets and the customers of the company they acquire .
- Within a year or so, the acquiring company must be able to provide top management for the company it acquires .
- Within the first year of a merger, it is important that a large number of people in management groups of both companies receive substantial promotion across the lines that is, from one of the former companies to the other .

Why Some Companies Do Better Than Others ?

Exercising due diligence : Company's able to apply due diligence is able to acquire leadership position in the industry . Lack of due diligence is lack of detail analysis of all important features like finance, management, capability physical assets as well as intangible assets results into failure . ISPAT Steel a corporate acquirer that conducts its mergers and acquisition activities after elaborate due diligence .

Financing : Cash is most preferred medium of exchange; According to KPMG in 1997 debt has gained a large importance of late . Highly successful and unsuccessful acquisitions show that debt was the only important factor . Ecolab increase its total debt 265% in its $ 5,00,000 purchase of Chemlawn . After the purchase. Ecolab had a debt equity ratio of 2 13, which result into poor financial performing for many years.

Looking for complementary resources : A firm with similar resources has highly similar strategic capabilities & vulnerability in the market place . So where a M & A that combines highly similar resources can result in a newly created firm that will encounter large quantity of virtually the same environmental opportunity & threats.

Friendliness : Success requires cooperation . Dennis Kozlowski, CEO of Tyco International and a major dealmaker says" It's like landing a plane at an airport with un co-operative air traffic controllers and ground crew . One of Kozlowski's Cardinal rules is that he never makes hostile bids .

Synergy : Synergies exist when assets are worth more when used in conjunction with each other than separately. Actual synergies for the firm over its rivals . RPL (Reliance Industries Ltd and Reliance Petroleum Ltd) . They become first private sector fortune global 500 Indian Company .

Integration : Uncovering the potential problems that could prevent the newly formed firm from operating in ways that create competitive advantages and value and to determine actions to take that prevent other integration-related difficulties . The best example is GE Caps . The intention of GE Caps managerial personnel has been to use its acquisition integration competitive advantage as an important means for the company's continuing growth.

Organizational fit : Organization structure with similar management problem, cultural system and structure . It facilitates resources sharing, enhancing the effectiveness of communication pattern and improving the company's capabilities to transfer knowledge and skills .

Distinction Between Merger And Acquisitions

Although often used synonymously, the terms merger and acquisition mean slightly different things. When one company takes over another and clearly establishes itself as the new owner, the purchase is called an acquisition. From a legal point of view, the target company ceases to exist, the buyer "swallows" the business and the buyer's stock continues to be traded. But a merger happens when two firms agree to go forward as a single new company rather than remain separately owned and operated. This kind of action is more precisely referred to as a "merger of equals". The firms are often of about the same size. Both companies' stocks are surrendered and new company stock is issued in its place. For example, in the 1999 merger of Glaxo Wellcome and SmithKline Beecham, both firms ceased to exist when they merged, and a new company, Glaxo SmithKline, was created.

In practice, however, actual mergers of equals don't happen very often. Usually, one company will buy another and, as part of the deal's terms, simply allow the acquired firm to proclaim that the action is a merger of equals, even if it is technically an acquisition. Being bought out often carries negative connotations, therefore, by describing the deal euphemistically as a merger, deal makers and top managers try to make the takeover more palatable. An example of this would be the takeover of Chrysler by Daimler-Benz in 1999 which was widely referred to as a merger at the time. A purchase deal will also be called a merger when both CEOs agree that joining together is in the best interest of both of their companies. But when the deal is unfriendly (that is, when the target company does not want to be purchased) it is always regarded as an acquisition.

Objectives of M & A

Economy of scale: This refers to the fact that the combined company can often reduce its fixed costs by removing duplicate departments or operations, lowering the costs of the company relative to the same revenue stream, thus increasing profit margins.

Increased revenue or market share: This assumes that the buyer will be absorbing a major competitor and thus increase its market power (by capturing increased market share) to set prices.

Synergy: Managerial economies such as the increased opportunity of managerial specialization. Economies due to increased order size and associated bulk-buying discounts.

Taxation: A profitable company can buy a loss maker to use the target's loss as their advantage by reducing their tax liability. In the United States and many other countries, rules are in place to limit the ability of profitable companies to "shop" for loss making companies, limiting the tax motive of an acquiring company.

Resource transfer: resources are unevenly distributed across firms (Barney, 1991) and the interaction of target and acquiring firm resources can create value through either overcoming information asymmetry or by combining scarce resources.

Vertical integration: Vertical integration occurs when an upstream and downstream firm merge (or one acquires the other). There are several reasons for this to occur. One reason is to internalise an externality problem. A common example is of such an externality is double marginalization. Double marginalization occurs when both the upstream and downstream firms have monopoly power, each firm reduces output from the competitive level to the monopoly level, creating two deadweight losses. By merging the vertically integrated firm can collect one deadweight loss by setting the downstream firm's output to the competitive level. This increases profits and consumer surplus. A merger that creates a vertically integrated firm can be profitable.

Diversification: While this may hedge a company against a downturn in an individual industry it fails to deliver value, since it is possible for individual shareholders to achieve the same hedge by diversifying their portfolios at a much lower cost than those associated with a merger.

Pitfalls in Mergers and Acquisition

In a recent Harvard Business Review article puts the failure rate at 70-80%. It does not matter whether the companies are large or small or in consumer goods or in technology the results are the same .This is because mergers and acquisitions are extremely difficult. Expected synergy values may not be realized and therefore the merger is considered a failure. The reasons for failures and the pitfalls of mergers can be poor strategic fit ,cultural and social differences ,incomplete and Inadequate due diligence ,poorly managed integration, paying too much , limited focus ,failure to get an objective evaluation of the target company's condition , failure to take immediate control, failure of top management to follow up changing business models.

A company that lacks imagination before acquisition is hardly likely to be more talented afterwards. A proper framework is necessary for merger and acquisition policy.

Conclusions

The past couple of years have seen a spate of M & A activity . Merger and acquisition from high tech companies to small traditional company have captured headlines for a decade . Many of the company go for it for increasing scale of operation, reduction in tax, improving financial performance and for competition . Last decades is a witness for most of the big M & A failure . Rather, when M & A's fail its frequently because of people or related issues . Acquirers has to do lot of homework in formulating strategy . A issue like cultural also play an important role in deciding success or failure . M & A activity demands lots of wisdom, insight, sensitivity, perseverance and planning to succeed .

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