M&A AND CORPORATE RESTRUCTURING

CA Final | AFM

Last Day Revision Notes / Summary Notes / Concept Notes

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- Faculty | CA Final, AFM & CFA
- Taught ~4,000 Students of CA & CFA
- Deeply Passionate about Financial Markets

& Economics

Acquisitions - one player buys out the other to combine with itself, by

- a purchase, where one business buys another (or)
- a management buyout, where the management buys the business from its owners.

Amalgamation

- Absorption and blending of one by the other (or)
- Two or more companies join to form a new company.

Demerger, a form of corporate restructuring in which the entity's business operations are segregated into one or more components.

A Cross-border merger is a merger of two companies that are in different countries. Eg: Indian company merging with a Foreign Company or vice versa.

Rationale for M&A
Synergy i.e
V(A) + V(B) > V(AB)

- Eefficiency Improvements
- Economies of Scale
- Diversification
- Taxation
- Growth
- Managerial Talent
- Consolidation

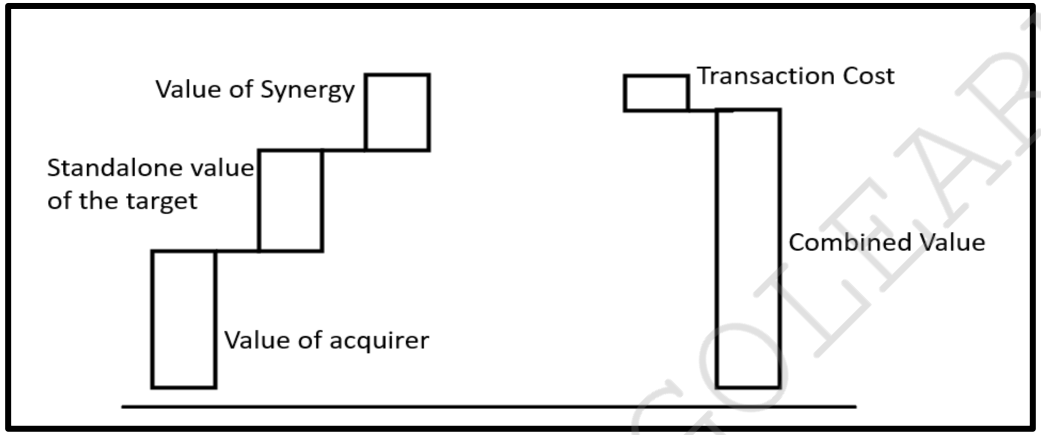
Objectives of Amalgamation

- Horizontal growth to achieve size, market share, curb competition, use unutilised capacity.
- Vertical combination to economise costs and eliminate taxes
- Business Diversification
- Utilise idle funds lying with another company for business expansion.
- Merger of export, investment, or trading company with an industrial company or vice versa to increase cash flow.
- Merging subsidiary company with the holding company to improve cash flow.
- Taking over a shell company with licenses or Nourishing a sick unit in the group

Merger Types

- Horizontal – Competitors
- Vertical – Buyers / Sellers
- Conglomerate - Unrelated
- Congeneric – Related industry but Diff products
- Reverse – Small acquiring Big, usually a Shell acquiring Public Co.
- Acquisition – Acquiring controlling interest

Gains/ Synergy from Mergers



Scheme of Amalgamation: A document outlining transfer of assets, consideration, rights, obligations etc

Appointed Date: Date on which the merger/transfer takes place

Effective Date: Date on which the merger is completed, and the merged companies are dissolved by the RoC.

Take Over Process

- Friendly – Target Board Agrees for acquisition
- Hostile – Target Board disagrees & Acquirer forced to make an open offer

Hostile Takeover → Strategies / Tactics

Street Sweep

Acquirer picks up large stake in target before making an Open Offer

Bear Hug

Acquirer threatens Open Offer & Target agrees for a settlement

Strategic Alliance

Start as a partner & takeover in due course

Brand Power

Ally with powerful brands to displace competing Brands

Factors considered in Financial Evaluation in an M&A Deal

- What is the maximum price of the target company?
- What are the principal areas of risk?
- What are the cash flow and balance sheet implications of the acquisition?
- What is the best way of structuring the acquisition?
- Valuation differs on a case/case basis
- How to pay for Acquisition? (cash / stock / mix)

Practical Questions Tips

1

	Acquirer	Target
EPS in Rs.	30	20
EPS Ratio	3	2
Swap Ratio (ULTA)	2	3
Swap Ratio i.e 2 Shares of Acquirer exchanged for 3 Shares of Target		

2

Market Capitalization (Mcap) Rs. =
Market Price per Share (Rs.) x Total Share Count (Nos.)

3

Promoter Holding (%) = Shares Held By Promoter x 100 / Total Share count of Company

4

Free Float (%) = 100% - Promoter Holding %

5

Free Float Mcap = Total Mcap in Rs. x Free Float %

6

Exchange ratios used
- Ratio of EPS
- Ratio of Market Price of Shares
- Ratio of Intrinsic Value of Shares
- Ratio of Book Value of Shares

7

Usage of Weighted Average of various Swap / Exchange Ratios

	Acquirer (A)	Target (T)	Ratio (A:T)	Decimal (R =A/T)	Weights (W%)	Weighted (R x W%)
EPS	3	2	3:2	1.50	30%	0.45
Book Value	8	5	8:5	1.60	10%	0.16
Intrinsic Value	7	5	7:5	1.40	20%	0.28
Market price	2	1	2:1	2.0	40%	0.80
Weighted Average						**1.69**
	1.69	**1**	**1.69:1**	**1.69**	**100%**	**1.69**

Shares of A are valued at 1.69 & T at 1
⇒ Shares of Acquirer are more valuable
⇒ Swap Ratio is 1.69 Shares of T for 1 Share of A

8

When Question says Swap ratio of 1:2 without detailing who is Acquirer or Target, it usually implies
1 share of acquirer to be exchanged for 2 shares of the target

9

When Question mentions both Bonus and Split without specific order, it is first bonus followed by split

Practical Questions Tips (Cont'd)

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10
- Question states that Exchange ratio should be on a No-loss basis to shareholders;
- If Question is specific about EPS then use Ratio of EPS
- If question is not specific then solve using both EPS ratio as well as Current Market Prices Ratio

11
Post Merger Valuation of Combined Entity
- Sum of Pre Merger Mcaps + Synergy
- Use Acquirer PE for valuation of merged entity only if specified

12
True Cost of Merger For Acquirer
Post Merger M cap of Target – Consideration Paid (if available) , else
Post Merger M cap of Target – Pre Merger M Cap of Target

13
Gain from Merger
Value Received - Price Paid
Net Gain from Merger for Acquirer
Synergy Gain – Premium paid for target

14
Gains / Losses for shareholders of both firms (In M cap terms)
Post Merger share of M cap of A – Pre Merger Mcap A
Post Merger share of M cap of T – Pre Merger Mcap T

15
Gains / Losses for shareholders of both firms (In Share Price terms)
Post Merger Price per share of A – Pre Merger Price per share of A
Post Merger Price per share of Equivalent Shares of T – Pre Merger Price per share of T

16
Eg: Swap Ratio is 3 shares of Target for 2 share of Acquirer
⇒ 2 shares of A = 3 shares of T (i.e 1 share of A for 1.5 shares of T)
Assume Pre merger price of A =100 , T =80 & Post merger price of A = 105
⇒ Equivalent share price of T = 105/1.5 = 70
⇒ Gain / (Loss) to share holder of T = 70 – 80 = Loss of 10

17
Equivalent EPS
Eg: Swap Ratio is 3 shares of Target for 2 share of Acquirer
⇒ 2 shares of A = 3 shares of T (i.e 1 share of A for 1.5 shares of T)
Assume Pre merger EPS of A =20 , T =21 & Post merger EPS A = 24
⇒ Equivalent EPS of T = 24/1.5 = 16
⇒ EPS Gain /(Loss) to share holder of T = 16-21= Loss of 5

18
Maximum Exchange ratio acceptable to Acquirer
=> All benefits to Target & Pre Merger Value to Acquirer
Minimum Exchange ratio acceptable to Target
=> All benefits to Acquirer & Pre Merger Value to Target

19
Minimum Value acceptable to Promoters of Target
Market Value of Shares + Lost income of Promoters

20
Merger of Banks :Capital Reserves in post merger BS(Bal Fig) =
- Book value of Shares of Target
- \- FV of Shares in Acquirer issued to shareholders of Target

21
Restructuring of Companies
- Sources of Benefits = Usage of Benefits
- Compute Cash Balance
- Compute Revised balances of BS items

Takeover Defensive Tactics

Divestiture	• Divest or Spin off a business, reducing attractiveness
Crown Jewels	• Selling most attractive part of business
Poison Pill	• Dilute holdings ; issue Converts in case of Hostile Takeover
Poison Put	• Issue Bonds with redemption at very high premium
Greenmail	• Buy Back own shares from hostile takeover bidder
White Knight	• Sell out to a friendly Company instead of hostile bidder
White Squire	• Sell out to a Company Not interested in this business
Golden Parachute	• Offer hefty payouts to Key employees in case of a Hostile Takeover
Packman Defence	• Try and Acquire the acquirer in a hostile manner

Demerger: Involves a company selling one of its divisions or & is used in following cases:

- Restructuring of an existing business
- Division of family managed business
- Management buy-out

Reasons for divestment or demerger

- To pay attention on core areas of business
- Divest Non-contributing business
- Business being too big to handle
- Meet Urgent cash requirement

Sell Side Imperatives

- Increasing competitor pressure.
- No access to new technologies and developments
- Strong barriers to market entry
- Poor positioning on supply and demand side
- Inability to achieve Critical mass
- Inefficient utilisation of distribution capabilities
- Inability to develop New strategic business units for future growth
- Inadequate capital to complete the project
- Window of opportunity: Possibility to sell the business at an attractive price
- Focus on core competencies

In the best interest of the shareholders – where a large well-known firm brings up the proposal, the target firm may be more than willing to give up.

Reverse Merger

- Smaller company gains control of a larger one
- Used for Sick Company Revival
- Also Known as Backdoor Listing

Tests to be satisfied

- Assets of transferor > transferee
- Equity capital issued by transferee > original capital.
- The change of control in the transferee company through the introduction of a minority holders

Benefits for the acquirer

- The assets of the transferor company are greater than the transferee company.
- Equity capital to be issued by the transferee company pursuant to the acquisition exceeds its original issued capital.
- The change of control in the transferee company through the introduction of a minority holder or group of holders.

Financial Restructuring

Need - Inability to repay debt - Stakeholders come together to protect & stabilize the entity

Meaning - refers to changes made by the management in Assets and Liabilities stakeholders' consent.

Suitable for entities with sizeable losses over a period with negligible NW

Aimed at reducing the debt/payment burden of the corporate firm.

Results in

- Reduction/Waiver in stakeholder claims
- Revaluing properties/assets & using Revaluation profits to w/o accumulated losses / fictitious assets

Forms of divestment/ demerger/ divestitures

Sell off

- It is of an asset, factory, division, product line or subsidiary by one entity to another
- Reasons
  - Non-Core
  - Combined businesses undervalued due to poor synergy
  - Raise cash to pay off debts.

Spin-off

- A part of the business is separated as new Entity
- The existing shareholders get proportionate ownership.
- There is no change in ownership
- Separate identity to a division.
- Valuable division is spun-off. As takeover defence
- To separate regulated & unregulated businesses

Split-up

- Breaking up entire firm into a series of spin-off.
- The parent firm no longer legally exists
- Newly created entities survive.
- Divisions become separate legal entities
- Enhances shareholders value and bring efficiency /effectiveness.

Equity Carve-outs

- Defined as partial spin-off - create new subsidiary and IPO it.
- Control retained with parent
- Generates cash from IPO
- Unlocks the value of subsidiary unit
- Enhances parent's value.

Demerger /Division of Family-Managed Business

- Pressure to yield control to professional managements.
- Hive off divisions meet succession problems.
- Consolidating core businesses

Types of Ownership Restructuring

Leveraged buyout (LBO)

- Acquisition happens using borrowing
- Target assets used as collateral
- Target no longer remains public post LBO
- Intent – to improve operational efficiency , sales & cash flow
- Post LBO, target managed by private investors.
- Post turn around & Debt repayment, may go public again.
- Large acquisitions without having to commit a lot of capital.

Equity Buy-Out

- Company Buys back own shares
- Results in Capital Reduction.
- Strengthens promoter's position
- Company uses surplus cash to buy shares from the public.

Management Buy-Out

- Buyouts initiated by the management team of a company
- The company is bought by its own management team.
- MBOs used to exit non-core divisions

Going Private

- Listed company is converted into a private company
- Buys Back all Shares OS in the markets.
- Happens when there are no benefits of being a public company.

How to Unlock Value through M&A

- Horizontal growth helps achieve optimum size, enlarge the market share, curb competition and use unutilized capacity.
- Vertical combination helps to economize costs and eliminate avoidable taxes /duties.
- Diversification of business.
- Utilize idle funds of target for the expansion
- Merger of an export, investment, or trading company with an industrial company or vice versa with a view to increase cash flow.
- Merging subsidiary company with the holding company to improve cash flow.
- Taking over a 'shell' company with licenses
- Nourishing a sick unit in the group & maintain group image.

How to Unlock Value through business restructuring

- Competitive positioning
- Surviving adverse economic climate,
- Providing a new direction.

Impact of Share BuyBack

- Increase in Promoter Holding
- Increase in EPS & MPS
- Reduction in cash & Equity
- Financing Cash Outflow
- Increase in ROA & ROE

Premium Vs. Discount in an M&A Deal

- Timing is a critical in an M&A deal
- During bull phase, there are more buyers but not sellers
- Synergies non-realization risk is high due to corporate, market, economic reasons, or wrong estimation
- Have range of values for the transaction in different situations
- Use transaction multiple, comparable company, DCF, PE Ratio, NAV, past earnings approach etc

Steps in a successful M&A programme

1. Manage pre-acquisition phase
2. Screening candidates.
3. Eliminate disqualified
4. Value the rest
5. Negotiate & execute
6. Post-merger integration

- Secrecy during Pre acquisition phase to avoid price increase of target
- Synergy depends on management
- Integration of processes & Culture, a must
- Target managers waste time on bureaucracy
- Motivated Managers a must for successful integration

Reasons for M&A Failure

- Acquirers overpay
- Synergy over-estimated
- Poor post-merger integration
- Psychological barriers

Acquisition Through Shares

Estimate Acquirers Value → Estimate Target's Value → Determine Exchange Ratio → Analyse various scenarios

- Target Shareholders will agree only if they benefit in terms of Share price
- The value of combined business = combined earnings x combined PE ratio.
- A lower combined PE ratio can offset the synergy gains
- A higher P/E ratio can lead to higher value of business, even if there is no synergy.

Factors Influencing Cross Border M&A

Globalization of production and distribution of products and services. → Integration of global economies. → Expansion of trade and investment relationships on international level. → Take Advantage of investment and tax incentives for foreign investment. → Privatisation of state-owned enterprises and consolidation of the banking industry

SPAC – Special Purpose Acquisition Company

- SPAC Raises money through IPO
- Money used to Merge with a Company to be identified later
- Shell firm structure is often called a "blank-cheque company
- IPO proceeds held in a trust till acquisition is made
- If Acquisition not made within a period, money returned net of costs
- IPO shareholders have option to redeem shares if they do not like the target
- SPAC target is announced only after Agreements are signed
- SPAC faces Complex accounting & financial reporting/registration requirements
- Should be ready to operate as a public Company within 5 months from Letter of Intent
- India does not support SPACs
- IFSC Gandhinagar, published a white paper exploring feasibility in India

Need & rationale for M&A

- Instantaneous growth, Snuffing out competition, Increased market share
- Acquisition of a competence or a capability
- Entry into new markets/product segments
- Access to funds
- Tax benefits

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