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## Mergers and acquisitions

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### Abstract

A merger is the process of joining 2 companies together to become one entity on equal terms, by agreement. An acquisition is when one company takes over another. Companies merge for several reasons some of which are: to expand a company, expand into new segments, or gain market share to increase shareholder value. Other reasons for companies to merge are to accelerate growth; diversify products or markets.

**Keywords:** mergers, acquisition

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### Introduction

Mergers and acquisition may be similar, however; they should not be confused for one another. A merger is the process (by agreement) of joining together of 2 companies on equal terms, to become one entity (EduPristine, 2015). An acquisition is when one company takes over another. If the corporate leadership of the company does not change much, it is probably an acquisition. However, if the company experiences significant restructuring, it is a merger.

There are several reasons why companies merge. Some of these reasons are: to expand a company, expand into new segments, or gain market share to increase shareholder value. Mergers can take place by purchasing assets, common shares by exchanging shares for assets, or by exchanging shares for shares (DePamphilis, 2015)<sup>[1]</sup>. Other reasons for mergers and acquisitions are: financial synergy for lower cost of capital, to improve a company's performance and accelerate growth; diversify products, markets, and risk; increase market share; for economies of scale; strategic realignment and technological change; and tax considerations.

### Mergers and Acquisition

A merger can take place through absorption or consolidation. Mergers can also be classified into three types: a). horizontal, b). vertical, and c). conglomerate. A merger is said to be horizontal when the two companies are in the same industry. It is vertical when the two companies are at different production stages or value chain; and conglomerate when the two firms are in unrelated industries. However; from a legal perspective, a merger can also be classified as: short form merger, statutory merger, subsidiary merger, and merger of equals.

Mergers and acquisitions (M&As) are important change agents and are critical components of any business strategy. As globalization increases, and change in technologies continues to accelerate, more and more companies are using mergers and acquisitions as a strategy for growth. Acquisitions remain the quickest route companies have to new markets and new capabilities.

Shareholders need to analyze each company involved in the merger to determine if it is a good investment. Shareholders have

the right to vote for or against the merger. Taking a close look at both companies' financials will tell shareholders what influenced the other company's interest in a merger. There will be a few noticeable changes in the new company such as a change in leadership (Elmerra, 2020)<sup>[4]</sup>. Management therefore, has to demonstrate skills at working with all the people involved in the newfound company (Jeh, 2019)<sup>[7]</sup>.

In an acquisition, the corporate leadership of the new company does not change much. However; in a merger, there is a significant restructuring. A merger is usually not completed under the initially proposed terms.

### M&A Process

Mergers and acquisitions (M&A) process has many steps and can take between 6 months to several years to complete.

1. The acquiring firm must assess itself to ensure that there is need for M&A. Then the acquirer develops a strategy with a clear idea of what they expect to gain from M&A.
2. **Set the M&A search criteria:** Buying company (acquirer) need to determine the key criteria for identifying potential target companies.
3. **Search for potential acquisition targets:** The acquiring firm must search for perfect target candidates. Then, a short-list of targets must be compiled after screening. The acquiring firm must diligently evaluate target candidates.
4. **Begin acquisition planning:** The acquirer makes contact with the target companies. It will then select a potential target. Once the target company is selected, negotiations will start so that the two firms can come to consensus. Both companies need to agree mutually to the deal.
5. **Perform valuation analysis:** if initial contact and conversations went well, the acquirer will ask the target company to provide its financials for evaluation.
6. **Make a Reasonable Offer:** The acquirer will make a reasonable offer; then, the 2 companies will negotiate.
7. **Take due diligence:** Acquirer conducts a detailed examination and analysis of the target firm. Financial reports for the companies should be analyzed to decide if it is a good

investment decision. Non-financial issues should also be considered in deciding on merger deals.

8. **Final Contract:** A final contract for sale is made; The 2 parties will decide if it is to be an asset purchase or share/stock purchase.
9. **Financing Strategy:** Financing Strategy for the acquisition is decided by the acquirer after the purchase agreement.
10. **Closing and Integration of the Acquisition:** The acquisition deal closes, and management teams of the target company and acquirer work together on the process of merging the two firms. Then, both companies will make a formal announcement of the merger agreement.

One of the most complicated steps in the M&A process is properly structuring the deal. The 2 important documents in M&A are: Term Sheet (used for raising money) and a Letter of Intent (LOI) which lays out the basic terms of the proposed deal. Companies normally have to pay a "premium" to acquire the target company. One of the biggest steps in the M&A process is analyzing and valuing acquisition targets. This usually involves two steps: valuing the target company on a standalone basis and valuing the potential synergies of the deal.

There are two types of synergies to consider: hard and soft (DePamphilis, 2015)<sup>[1]</sup>. Hard (operating) synergies are direct cost savings to be realized after completing the merger and acquisition process. Hard synergies are benefits that arise from the merger or acquisition e.g. payroll saving from eliminating redundant personnel from the 2 firms. Soft synergies (financial synergies), are revenue increases that the acquirer hopes to realize after the deal closes. Soft synergies are not as assured as the hard synergy cost savings.

### Types of Mergers

Some types of mergers are: triangular merger, forward triangular merger, and reverse triangular merger.

**Triangular merger:** This is where the target company merges with an acquiring company that is wholly owned by the acquirer; and the target company becomes a subsidiary of the acquirer.

**Forward triangular merger:** In this type of merger, the target company merges into the acquirer's subsidiary.

**Reverse triangular merger:** This is similar to forward triangular merger except that the subsidiary merges into the target company.

### Reasons for failure of M&A

There are some reasons why M&A fails. Some of these reasons are:

1. **Poor Strategic Fit:** There may be wide differences in objectives and strategies of both companies. These differences may cause M&A failure if not successfully addressed.
2. **Poor Integration Management:** Integration of the 2 companies may be poorly managed with little or no planning; which may lead to failure of implementation.
3. **Little or No Diligence:** Inadequate due diligence of both companies can lead to failure of the M&A.

4. **Being Overly Optimistic:** If and when the acquiring company is too optimistic about the target company, it may lead to bad decisions and failure of the M&A.

### Advantages of M&A

There are some advantages to M&A. Some of these advantages are listed below.

1. help in achieving economies of scale
2. increase market share/reach,
3. enhance financial strength and flexibility
4. Enables diversification of products, markets, or risk
5. strategically realigns technological change

### Goodwill

The share price of the company being bought will increase because goodwill is taken into consideration in the purchase price. Goodwill is the amount of money a company pays over the book value of another company to purchase it. Goodwill is an intangible asset; which is not always easy to value. Sometimes, a company may overvalue it. This is not good for the purchasing company, but is a win-win for the shareholders of the target company.

### Disadvantages

Some disadvantages to M&A are:

1. uncertainty regarding approval of the merger by shareholders
2. The newly formed company may face major difficulties due to frictions and internal competition that may arise among employees of both companies.
3. Delay in implementation of the M&A may result in increased costs for the companies
4. It is possible for a company being acquired to be overvalued especially in regards to its goodwill. Although this is a win for the acquiree; it is not good for the buying company.
5. There may be loss of experienced workers because redundant positions will be eliminated. Also, some workers may decide to leave after M&A announcement

### Elements for Success

1. The workforce should learn from each other's best practices.
2. There is need to reduce the workforce for the new company because of the cost efficiency inherent in combining redundant tasks.
3. Management should be honest with employees who will lose their jobs. It is kinder to hear about it upfront than to find a pink slip in the next paycheck. Employees are the most important asset and should be treated as such.
4. Management should understand or realize that merging two companies with different policies, procedures, and culture may create stress for all involved. Employees from both companies have to deal with new people, new procedures, possibly more work, and the loss of co-workers who had become their friends.
5. It is possible to lose some good people who are not comfortable with the new organization.
6. Employees should be given time to work through the changes before picking up full speed.
7. Product management, HR, and IT need to be aligned for the new formed company.

### Financing options

Although mergers and acquisition (M&A) are advantageous to the parties involved, M&A are very expensive because M&A deals involve investment banks and lawyers (idealsvdr.com, 2016). Therefore, companies need to seek financing options in order to pay for their M&A transactions. There are a number of different methods to finance M&A; however, the method chosen by a company depends on its condition at the time of the transaction. Some methods of financing are: cash, stock, bond, loan, etc.

### Financing With Stock

Stock transaction is the most common option for financing M&A deals. Stock pricing is probably what triggers M&A activity in the first place. The striking thing about acquisitions in the 1990s is the way they are paid for. In 1988, about 60% of the value of large deals (those over \$100 million) was paid for entirely in cash; less than 2% was paid for in stock. A decade later, 50% of the value of all large deals was paid for, entirely in stock.

In a typical stock transaction, the buying company exchanges shares in its company for shares in the selling company. Financing M&A with stock is a safe option because both parties share risks in the M&A and it guarantees careful management. Financing with stock is advantageous to an acquirer if its shares are overvalued on the market; as it will receive more stocks in the selling company.

The drawback in financing with this method is stock volatility. An example of this is the 2016 stock volatility. To avoid this, some companies use a mix of shares and cash. This action helps to reduce risk for both parties and allow them to maintain a stake in the new formed company. When shares are used to pay for M&A deals, it becomes unclear who is the buyer and who is the seller (Rappaport & Sirower, 1999)<sup>[6]</sup>. Companies that pay for acquisitions with stock will share both the value and the risks of the transaction with the shareholders of the target company. In a split, the number of the new company's shares received in exchange for one's stake in the former company is a ratio e.g. 2:1.

### Financing With Cash

In a cash deal, the roles of the two parties are clear-cut, and the exchange of money for shares completes a simple transfer of ownership. Cash transaction is instant and does not require complicated management like stock. Cash transaction is the preferred method; however, the price of M&A deals may be in the millions or even billions of dollars, which may be too expensive for some companies to afford. One drawback with cash transaction is exchange rate fluctuation if the M&A deal involves companies from different countries.

### Financing With Bonds

Corporate bonds are a quick and easy way of raising cash. When investors buy bonds, they are loaning money to the company in the expectation that they will receive a return on their capital over time. In 2015, analysts indicated that over \$290 billion of debt was raised for M&A deals, which almost triple the amount raised in 2014.

### Financing With Loan

Companies may borrow to finance M&A deals. Since the 2006-2008 world financial crises, loan is hard to obtain. A company should be careful of the interest rate charged on the loan because even if the interest rate is low, the cost could be expensive if the value of the M&A is high.

### Financing With IPO

Initial public offering (IPO) is a good way for a company to raise money. A company may decide to issue new shares to finance M&A. An IPO always attract market buzz, so by timing the IPO with an M&A transaction, a company can maximize investor interest and drive up early share prices (idealsvdr.com, 2016). An IPO can be a risky way of financing ventures because the market can fall just as easily as it can rise.

### Impacts of Methods of Financing

Studies indicated that, at time of M&A announcement, shareholders of acquiring companies fare worse in stock transactions than they do in cash transactions (Rappaport & Sirower, 1999)<sup>[6]</sup>. In cash transactions, the acquiring company's shareholders bear all the risk if the expected synergy value in the acquisition premium did not materialize. In a stock transaction, both shareholders of the target company and the acquirer bear the risk based on the percentage of shares owned (Rappaport & Sirower, 1999)<sup>[6]</sup>.

The expected net gain to the acquirer from an acquisition is called *shareholder value added (SVA)*, which equals synergy from acquisition minus acquisition premium i.e.  $SVA = S - AP$ . If acquirer decides to finance the acquisition by issuing new shares, the SVA for the acquirer stockholders will drop (idealsvdr.com, 2016).

In most acquisitions, the acquiring firm is bigger than the target firm (DePamphilis, 2015)<sup>[1]</sup>. In this case, the target firm will end up owning only a negligible proportion of the newly formed company. If the target firm is larger than the acquiring firm, then, it will be to the advantage of the target firm's shareholders. If the deal is financed with stock, the potential risk to the acquired (target) firm's shareholders is large.

If fixed shares are offered for the deal, then, the percentage of ownership for both shareholders will not change even if the acquirer's share price changes; SVA may though. If the acquirer's share price falls, the acquired firm's shareholders will bear a price risk. If on the other hand price increases, then the shareholders will gain.

In a buyout, if the company being bought has reputable performance and good prospects for the future, some amount of goodwill (the amount over the book value) may be involved. This goodwill may be a windfall for the shareholders. A buyout may be a reverse takeover where a small company takes over a larger and/or longer-established company and retains the name of the larger company after the acquisition. Almost all studies report positive returns for the shareholders in both companies, which imply that M&A creates economic value for shareholders (Douma & Schreudder, 2013)<sup>[2]</sup>.

### Conclusion

Mergers and acquisition should not be confused for one another although they may be similar. A merger is the process of joining 2 companies together on equal terms, to become one entity while

an acquisition is when one company takes over another. Mergers and acquisition help increase company market share. The share price of the company being bought will increase because goodwill is reflected in the purchase price. Goodwill is not always easy to value; therefore, sometimes a company may overvalue it (goodwill). The best method to finance M&A for a company depends on its share situation, debt liabilities, and the total value of its assets.

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