Art'o'val Advisors

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Valuation Series

11 – Valuation under Special Situations

November 2023

Overview of Special Situations

Types of Special Situations

- Mergers and acquisitions are deals in which two or more companies merge in some way. Despite the fact that the terms mergers and acquisitions (M&A) are sometimes used interchangeably, they have distinct legal meanings.

Mergers

- One firm absorbs the assets and liabilities of the other firm in a merger. The acquiring firm retains its identity. In many cases, control is shared between the two management teams. Transactions were generally conducted on friendly terms.
- In a consolidation, an entirely new firm is created.

Acquisitions

- Traditionally, the term described a situation when a larger corporation purchases the assets or stock of a smaller corporation, while control remained exclusively with the larger corporation.
- Often a tender offer is made to the target firm (friendly) or directly to the shareholders (often a hostile takeover).

Demerger

- Splitting up of a division/business of an existing company into a new company/existing separate operating company.
- The shareholders of original company would generally receive shares of the new entity

Overview of Special Situations Contd..

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Carve-out

- Carve-out is the partial divestiture of a business unit in which a parent company sells a minority interest of a subsidiary to outside investors.
- Company undertaking a carve-out is not selling a business unit outright but, instead, is selling an equity stake in that business or relinquishing control of the business from its own while retaining an equity stake.
- Carve-out allows a company to capitalize on a business segment that may not be part of its core operations.

Spin-off

- Spinoff is a new and separate company that's created when a parent company distributes shares in a subsidiary or business division to the parent company shareholders, It is a type of divestiture.
- A parent company creates a spinoff expecting that it will be worth more as an independent entity than it was as part of the parent company.
- Spinoff is also known as a spinout or starburst.

Buyback

- A buyback, also known as a share repurchase, is when a company buys its own outstanding shares to reduce the number of shares available on the open market.
- Companies buy back shares for a number of reasons, such as to increase the value of remaining shares available by reducing the supply or to prevent other shareholders from taking a controlling stake.

Merger Negotiations

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What are Negotiations ?

- Negotiation is the mutual debate and structuring of the conditions of a transaction in order to reach a settlement or agreement.
- Negotiation is the most critical step when it comes to mergers and acquisitions. It is the stage where the deal either comes together with the way the negotiators want it to or falls apart because their efforts have exhausted them.

Friendly Acquisition

- The acquisition of a target company that is willing to be taken over.
- Usually, the target will accommodate overtures and provide access to confidential information to facilitate the scoping and due diligence processes.

Hostile Takeover

- A takeover in which the target has no desire to be acquired and actively rebuffs the acquirer and refuses to provide any confidential information.
- The acquirer usually has already accumulated an interest in the target (20% of the outstanding shares) and this preemptive investment indicates the strength of resolve of the acquirer.

Term	Definition
Target	The corporation being purchased, when there is a clear buyer and seller.
Bidder	The corporation that makes the purchase, when there is a clear buyer and seller. Also known as the acquiring firm.
Friendly	The transaction takes place with the approval of each firm's management.
Hostile	The transaction is not approved by the management of the target firm.

Fundamental Reasons for M&A

Synergies	Through the integration of business operations, there is a tendency for a boost in overall performance efficiency, accompanied by a reduction in overall costs. This occurs as each company capitalizes on the strengths of the other.
Increase Supply – Chain Pricing Power	Acquiring one of its suppliers or distributors enables a business to eliminate an entire tier of costs. In the case of purchasing a supplier, termed a vertical merger, the company typically reduces costs by saving on the margins previously added by the supplier. Conversely, acquiring a distributor often empowers the company to sell its products at a lower cost.
Eliminate Competition	Numerous M&A deals provide the acquiring company with the opportunity to eliminate future competition and secure a more substantial market share. However, on the flip side, offering a significant premium is often necessary to persuade the shareholders of the target company to accept the proposal.
Growth	Mergers offer the acquiring company a chance to expand its market share without undertaking substantial efforts. In these instances, acquirers simply purchase a competitor's business, a process commonly known as a horizontal merger.
Succession and retirement	One of the primary catalysts for M&A activity is when owners are seeking retirement or aiming to transfer the business to successors or potential buyers. In such cases, owners often seek strategic buyers who possess a deep understanding of the business. This choice is driven by the desire for a seamless transfer that ensures continuity for employees and other stakeholders involved.

Types of Merger

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Type	Description
Horizontal Merger	➢ A horizontal merger occurs when two companies operating in the same market (and selling similar products or services) come together to dominate market share. ➢ This type is attractive for merging companies aiming to build economies of scale and decrease market competition.
Vertical Merger	➢ Vertical mergers involve two companies in the same industry who operate in different stages of production. This could involve a retailer who merges with a wholesaler, or a wholesaler merging with a manufacturer. ➢ This type of merger is ideal for streamlining operations, boosting efficiencies, and cutting costs across the supply chain.
Congeneric Merger	➢ A merger is considered congeneric if the companies offer different products or services but operate in the same sphere and sell to the same customer base. ➢ Congeneric mergers allow companies to sell new products, which is why they're also known as product extension mergers.
Conglomerate Merger	➢ Conglomerate merger occurs between two companies whose business activities and industries may be completely unrelated. ➢ In pure conglomerate mergers, the two firms may continue to operate separately within their own markets, whereas in a mixed one, they may look to expand product or market reach.
Market Extension Merger	➢ A market extension merger is a horizontal merger that allows two companies that sell the same product to operate in a new market. ➢ These types of consolidations help companies drive more revenue by expanding where they do business.
SPAC Merger	➢ Special Purpose Acquisition Company (SPAC) is a company without commercial operations and is formed strictly to raise capital through an initial public offering (IPO) for the purpose of acquiring or merging with an existing company. ➢ Also known as blank check companies, SPACs have existed for decades, but their popularity has soared in recent years.

Synergies in M&A

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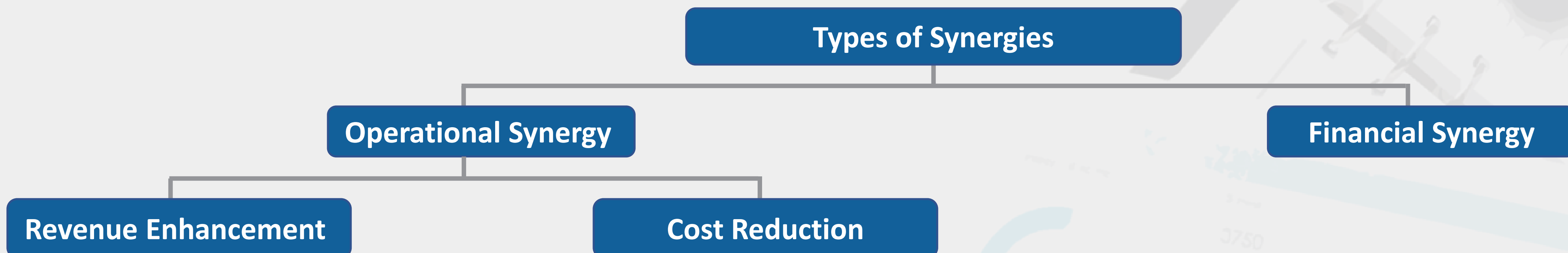
What are Synergies in M&A?

- Mergers and acquisitions are made with the goal of improving the company's financial performance for the shareholders.
- Two business can merge to form one company that is capable of producing more revenue than either could have been able to independently, or to create one company that is able to eliminate or streamline redundant process, resulting in significant cost reduction.
- Because of this principal, the potential synergy is examined during the merger and acquisition process.
- If two companies can merge to create greater efficiency or scale, the result is what is sometimes referred to as a synergy.
- Synergies are the estimated cost savings or incremental revenue arising from a mergers and acquisitions (M&A).
  - ✓ Suppose firm A is contemplating acquiring firm B
  - ✓ The synergy from the acquisition is
  - ✓ Synergy = $V_{AB} - (V_A + V_B)$
  - ✓ The synergy of an acquisition can be determined from the standard discounted cash flow model: Synergy = $\sum_{t=1}^{T} \frac{\Delta CF_t}{(1+r)^t}$



Types of Synergies

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Revenue Enhancement

- Revenue synergies are based on the assumption that the combined companies can generate more cash flows than if their individual cash flows were added together.
- Hence, these benefits in M&A must be pitched as being mutually beneficial, as opposed to being one-sided exchanges.
- Frequently referred to as the "phase-in" period, synergies are typically realized two to three years post-transaction.

Cost Reduction

- Cost synergies tend to be more likely to be realized and therefore are viewed as more credible, which is attributable to how cost synergies can point towards specific cost-cutting initiatives such as laying off workers and shutting down facilities.
- Acquirers must often accept that the expected synergies used to justify a purchase price premium may not ever materialize.

Financial Synergy

- Financial synergy is when two mid-sized companies merge together to create financial advantages.
- In comparison, the topic of financial synergies is more of a gray area, as quantifying the benefits is more intricate relative to the other types.
- But some commonly cited examples include the following:
  - ✓ Tax Savings from Net Operating Losses
  - ✓ Greater Debt Capacity
  - ✓ Lower Cost of Capital

Mode of Financing Merger

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Stock Swap Transaction

- When companies own stock that is traded publicly, the acquirer can exchange its stock with the target company.
- Stock swaps are common for private companies, whereby the owner of the target company wants to retain a portion of the stake in the combined company since they will likely remain actively involved in the operation of the business.
- The acquiring company often relies on the proficiency of the owner of the target firm to operate effectively.

Acquisition Through Equity

- In acquisition finance, equity is the most expensive form of capital.
- Equity financing is often desirable by acquiring companies that target companies that operate in unstable industries and with unsteady free cash flows.
- Acquisition financing is also more flexible, due to the absence of commitment for periodic payments.

Cash Acquisition

- In an all-cash acquisition deal, shares are usually swapped for cash.
- The equity portion of the balance sheet of the parent company remains the same.
- Cash transactions during an acquisition often happen in situations where the company being acquired is smaller and with lower cash reserves than the acquirer.

Acquisition Through Debt

- Debt financing is one of the favorite ways of financing acquisitions.
- Most companies either lack the capacity to pay out of cash or their balance sheets won't allow it.
- Debt is also considered the most inexpensive method of financing an acquisition and comes in numerous forms.
- When providing funds for an acquisition, the bank usually analyzes the target company's projected cash flow, profit margins, and liabilities.

Mode of Financing Merger Contd..

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Acquisition Through Mezzanine or Quasi Debt

- Mezzanine or quasi-debt is an integrated form of financing that includes both equity and debt features.
- It usually comes with an option of being converted to equity.
- Mezzanine financing is suitable for target companies with a strong balance sheet and steady profitability.
- Flexibility makes mezzanine financing appealing.

Leveraged Buyout (LBO)

- A leveraged buyout is a unique mix of both equity and debt that is used to finance an acquisition. It is one of the most popular acquisition finance structures.
- In an LBO, the assets of both the acquiring company and target company are considered as secured collateral.
- Companies that involve themselves in LBO transactions are usually mature, possess a strong asset base, generate consistent and strong operating cash flows, and have few capital requirements.
- The principal idea behind a leveraged buyout is to compel companies to yield steady free cash flows capable of financing the debt taken on to acquire them.

Seller's Financing / Vendor Take-Back Loan (VTB)

- Seller's financing is where the acquiring company's source of acquisition financing is internal, within the deal, coming from the target company.
- Buyers usually resort to the seller's financing method when obtaining capital from outside is difficult.
- The financing may be through delayed payments, seller note, earn-outs, etc.

Key Considerations

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Synergies	Synergy is the concept in which the augmented value generated by combining two companies is greater than the sum of separate individual parts. It creates opportunities that would not have been available to these businesses at their level.
Form of Consideration	The company must take into consideration how the buyers will pay, and the sellers will get paid. This is often considered by analyzing how the company views its business and the anticipated synergies from a merger or an acquisition.
Accounting	The companies may require financial and tax reports. It is important in the determination of goodwill in the M&A transactions. For instance, if the acquirer company purchases the acquired company and assigns that purchase amount into the assets and liabilities of the business, then these are to be used for both financial and tax purposes.
Intellectual Properties	Directly or indirectly, the intellectual property of a business plays a major role in a merger and acquisition transaction. It is any corporation's biggest asset and hence play a crucial role in determining the price of the business. . Transfer of intellectual property also benefits the acquirer with a transfer of technology which helps in its exploitation and utilization to the full extent.
Acquisition Premium	Acquisition premium is the difference between the price paid for an acquired company in a merger or acquisition and the acquired company's assessed market value. It is maintained on the acquirer's balance sheet as an intangible asset after the deal is completed.

Factors Driving the M&A

Lack of competency

- Another reason for divesting a business unit can be the lack of competency of the business unit in comparison with the other players in the industry.
- If a business unit is not competitive enough in the market this will lead to a lower market share which would in turn produce less profits.

Non-performance of assets and losses

- A company's management may choose to divest certain assets or divisions which are consistently non-performing.
- In this situation holding onto an asset may increase more losses and debts instead of earning profits and increasing productivity
- Hence divestiture of those non- performing and low value divisions is undertaken.

Anti-trust divestiture

- Sometime the companies are required to comply with certain regulations in order to decrease monopolies.
- In order to comply with such regulations and orders, the companies have to divest some of their business divisions or assets as per orders.

Changes in the market

- The outside factors play a key role in the growth and expansion of a company.
- There are certain factors such as the trends in the market, demand and value of a business in the market and the competition in the industry from other businesses.

Factors Driving the M&A contd..

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Bankruptcy	➢ In the event of a company not being able cope up with its accumulated debts, the company is declared bankrupt. ➢ During bankruptcy, a company may try to generate sufficient funds to pay back its debts through several sources. ➢ One of the ways by which the company can raise money is through divestiture. ➢ By selling of its business divisions and enterprises, the company can secure enough money to pay its debts and pay the creditors.
Location and geo-political scenario	➢ In areas of war and social conflict it is difficult for companies to operate and function with ease. ➢ As a result, the companies choose to divest their business divisions in that area until the situation becomes better. ➢ Companies such as PepsiCo. And Macy's decided to divest in Myanmar during its political crisis.
Financial factors	➢ In times of financial crisis, a company may decide to divest certain assets and business units. ➢ This divestment helps the company to raise funds which might be crucial for the future investments that the company might want to pursue. ➢ This could also help in eliminating debts that the company has accumulated.
Streamlining of the company's functions	➢ Sometimes a company has many different enterprises or business divisions under its ambit. ➢ Over the course of time, the company might realize that its future goals have changed. ➢ The company might also want to streamline its functional areas by eliminating certain divisions that are no longer consistent with its future goals.

Challenges in M&A

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Working in a Global Environment

- The consolidation and securing are by and large and generally done between the organizations having central command in various nations.
- This confuses the exchange of training as administrators by and large accept that their insight is ideal and applies all around and they neglect to understand that exhibition drivers shift from one culture to another.

Language Barrier

- The correspondence between the representatives is viewed as the greatest test.
- As the consolidated organizations are from various nations and language utilized among is unique and when such various organizations meet up the representatives appears to confine them from cooperating

Strategic Planning

- Routinely HR specialists are not enough drawn in with the evaluation of target associations before deals are settled upon.
- If they are not individuals in the improvement of an M&A approach and the screening of capacity and culture at a beginning phase, they should play look into later on, fixing issues that might have been avoided had they been incorporated from the start.

Planning Integration

- A significant test is to guarantee that the new business substance isn't impacted by the M&A's exercises.
- What's more, investigate worker's presentation to guarantee that client necessities keep on being met.
- Coordination arranging and activity should start before time as achievable before the arrangement closes.

Challenges in M&A Contd..

Lacking a good motive for the acquisition

- Issues of consolidations and acquisitions start even before an arrangement happens.
- The consolidation or obtaining has recently run into its first issue and the odds of other emerging areas of now higher as an immediate result.

Overestimating synergies

- In the least difficult terms, collaborations happen when one in addition to one is more noteworthy than two.
- This typically implies either expanded income or cost investment funds which are a result of the exchange.
- These are a solid intention in many arrangements, but at the same time, they're normally misjudged.

Failed Integration

- In fact, reconciliation comes after a consolidation or procurement, yet that doesn't mean it ought to be a reconsideration.
- Issues with acquisitions during Integration, which incorporate culture and change the board, can make a wasteful and surprisingly harmful workplace.

Deal Structure

- An exchange can be organized in three ways: Stock purchase; Asset sale, and Merger.
- Inside every choice, the purchaser and target have to restrict lawful interests and concerns.
- While arranging a specific arrangement structure, it's basic to comprehend and address material worries.

Accretion Dilution Analysis

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What is Accretion Dilution Analysis?

- Accretion and Dilution refer to a simple test that determines the impact of an acquisition or merger on the buying firm's Earnings Per Share (EPS).
- Accretion Dilution analysis helps the acquirer (buyer) weigh the consequences of the merger, incorporating all factors and complexities.

Accretion

- An accretive acquisition or merger is one where the pro forma (post-deal) Earnings per Share is greater than the acquirer's (buyer's) EPS before the deal is made.

Pro Forma (Post-Deal) EPS > Acquirer's EPS

Dilution

- A dilutive acquisition or merger is one where the pro forma (post-deal) EPS is less than the EPS of the acquiring business when it stands alone before the deal is made.

Pro Forma (Post-Deal) EPS < Acquirer's EPS

Breakeven

- This scenario is pretty self-explanatory. Upon a merger or acquisition, the acquiring (buying) company would essentially "breakeven." In other words, there would be no impact on the acquirer's EPS, and the company's EPS would be the same before and after the deal is made.

Pro Forma (Post-Deal) EPS = No Impact on Acquirer's EPS

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