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Mergers and Acquisitions

Logic of Corporate Level Strategy Applies

Corporate level strategy should create value:

A B C

A+B+C

1) such that the value of the corporate whole increases

2) such that businesses forming the corporate whole are worth more than they would be under independent ownership

3) that equity holders cannot create through portfolio investing

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Mergers and Acquisitions

DEFINITIONS

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Mergers and Acquisitions

Definitions

- MERGER
 - Combination of Two Firms of Which One Survives
- ACQUISITION
 - Bidder Buys All or Majority of Stock. Target Continues to Exist as Subsidiary or Associate
- HOLDING Co.
 - Purchase Only a Part of the Target Stock
- ASSET SALE
 - Only Assets Sold. Liabilities not Transferred

BYOL

TEMASEK.

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Mergers and Acquisitions Defined

Mergers

Acquisitions

- two firms are combined on a relatively co-equal basis
- one firm buys another firm

the words are often used interchangeably even though they mean something very different

merger sounds more amicable, less threatening

Handwritten notes: Stake. Mgmt. Control. 25%, 30%, 51%

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Mergers and Acquisitions Defined

Mergers

Acquisitions

- parent stocks are usually retired and new stock issued
- name may be one of the parents' or a combination
- one of the parents usually emerges as the dominant management
- can be a controlling share, a majority, or all of the target firm's stock
- can be friendly or hostile
- usually done through a tender offer

Handwritten notes: Agency Theory, Measure of Corporate Governance, Mkt for Corp. Control, Diversified Shareholder (Principles), Agent to Corp (Agents), Information Asymmetry

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Mergers and Acquisitions Defined

Types of M&A Activity

CCI FTC Categories

- Vertical » suppliers or customers
- Horizontal » competitors
- Product Extension » complementary products
- Market Extension » complementary markets
- Conglomerate » everything else

Handwritten notes: VI, Related, Related Div., Unrelated Div.

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Mergers and Acquisitions Defined

MOTIVATIONS

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Mergers and Acquisitions

Motivations for M&A

- Strategic realignment
 - Technological change
 - Deregulation
 - Diversification (Related/Unrelated)
- Synergy
 - Operating synergy
 - Market power
 - Financial synergy
- Financial considerations
 - Acquirer believes target is undervalued
 - Booming stock market
 - Falling interest rates
 - Tax considerations

Target:
 ↳ share price ↓
 ↳ Reserves & Surplus.

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Mergers and Acquisitions

Synergy

- Operating Synergy
 - Economies of Scale
 - Economies of Scope
- Costs of Operations is Lowered and Profit/Surplus Increases Due to Synergy
 - Resource/Asset Infusion
 - Downsizing
 - Renegotiating Contracts
 - Worker/Managers
 - Creditors
 - Government

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Mergers and Acquisitions

Synergy

- Market Power
 - Horizontal Integration
 - Leads to better control over the market and greater power to fix prices and thwart competition
 - Vertical Integration & Transaction Costs
 - Must lower costs through integration or strategic posture

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Mergers and Acquisitions

Synergy

- Financial Synergy Arises from Lower Financial Costs Faced by a Merged Firm
 - This arises from lower cost of raising finance
- Because of combined cash flows, the debt of the new entity is more secure, as prob. of bankruptcy declines

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Mergers and Acquisitions

Empirical Findings

- Around transaction announcement date, abnormal returns average
 - 20% for target shareholders in “friendly” transactions; 30-35% in hostile transactions
 - Bidders’ shareholders on average earn zero to slightly negative returns
- Positive abnormal returns to bidders often are situational and include the following:
 - Target is a private firm or a subsidiary of another firm
 - The acquirer is relatively small
 - The target is small relative to the acquirer
 - Cash rather than equity is used to finance the transaction
 - Transaction occurs early in the M&A cycle

announced
Target ✓
Acq. ✗

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Mergers and Acquisitions

Why Is M&A Activity So Prevalent?

If managers know that acquiring firms do not capture any value from M&A's, why do they continue to merge and acquire?

- Survival

 - avoid competitive disadvantage
 - avoid scale disadvantages
- Free Cash Flow

 - cash generating, normal return investment

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Mergers and Acquisitions

Why Is M&A Activity So Prevalent?

If managers know that acquiring firms do not capture any value from M&A's, why do they continue to merge and acquire?

- Agency Problems

 - Managers benefit from increases in size.
 - Managers benefit from diversification.
- Managerial Hubris

 - Managers believe they can beat the odds.

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Mergers and Acquisitions

Why Is M&A Activity So Prevalent?

If managers know that acquiring firms do not capture any value from M&A's, why do they continue to merge and acquire?

- Above Normal Profits

 - Some M&A activity does generate above normal profits (expected and operational over the long run).
 - Proposed M&A activity may satisfy the logic of corporate level strategy.
 - Managers may see economies that the market can't see.

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Mergers and Acquisitions

Motives for Mergers and Acquisitions

- **Managerial Motives**
 - Top management remuneration depends more on firm size than profitability
 - Psychological rewards--M&As project power, confer CEO celebrity status
 - Imitation: the fear of not participating in an industry's merger wave
- **Financial Motives**
 - Stock market inefficiencies—acquire undervalued companies (Berkshire Hathaway-Heinz): use overvalued equity to acquire (AOL-Time Warner)
 - Quest for tax savings—cross-border acquisitions to relocate to lower tax regime (Burger King-Tim Horton)
 - Financial re-engineering: debt-financed acquisitions that reduce the acquired company's cost of capital (KKR-RJR Nabisco)
- **Strategic Motives**
 - Horizontal M&A—economies of scale and market power (Sirius-XM)
 - Geographical extension M&A—to enter overseas market (ENEL-Endesa)
 - Vertical M&A—to acquire supplier or customer (Gencore-Xstrata)
 - Diversifying M&A—to enter a new area of business (Kering-Puma)

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Mergers and Acquisitions

Competitive Advantage

Doing the Deal

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Mergers and Acquisitions

Competitive Advantage

Doing the Deal

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Mergers and Acquisitions

VALUE CREATION

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Mergers and Acquisitions

Do Mergers and Acquisitions Create Value?

The Logic

Related M&A Activity

- value creation would be expected due to synergies between divisions
 - economies of scale
 - economies of scope
 - transferring competencies
 - sharing infrastructure, and so on

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Mergers and Acquisitions

Do Mergers and Acquisitions Create Value?

The Logic

Unrelated M&A Activity

Business Groups.
Institutional Voids.
Internal Mktb.
↳ Human
↳ Financial.

- there would be no expectation of value creation due to the lack of synergies between businesses
- there might be value creation due to efficiencies from an internal capital market
- there might be value creation due to the exploitation of a conglomerate discount
 - a corporate raider who buys and restructures firms

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Mergers and Acquisitions

Do Mergers and Acquisitions Create Value?

The Empirical Evidence

19th Nov.
24th Nov.
29th Nov.

Research is based on stock market reaction to the announcement of M&A activity

- this reflects the market's assessment of the expected value of the merger or acquisition
- these studies look at what happens to the price of both the acquirer's stock and the target's stock
 - thus, we can see who is capturing any expected value that may be created

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Mergers and Acquisitions

Do Mergers and Acquisitions Create Value?

The Empirical Evidence

M&A Activity creates value, on average, as follows:

Acquiring Firms

• no value created

Target Firms

• value increases by about 25%

- related M&A activity creates more value than unrelated M&A activity

M&A activity creates value, but target firms capture it.

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Mergers and Acquisitions

Are Mergers Successful?

- Evidence from Shareholder Returns:
 - Small increase in the combined value of the 2 companies involved
 - Gains flow (almost) entirely to shareholders of acquired companies
 - Returns to shareholders of acquiring companies negative on average
- Evidence from Accounting Profits
 - Diverse findings: "...the results from these accounting-based studies are all over the map"
 - Key problem: separating the effects of the merger from the many other factors that influence firms' profitability
- Diversity of M&A
 - Lack of consistent findings reflects the vast diversity in types of mergers and characteristics of the firms involved
 - Even when mergers categorized (e.g. horizontal, vertical, conglomerate) no consistent performance differences

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Mergers and Acquisitions

Empirical Findings

- Primary Reasons Some M&As Fail to Meet Expectations
 - Overpayment due to over-estimating synergy ~~\$0.5~~
 - Slow pace of integration \$5000
 - Poor strategy

Premium
~~\$10~~ acq.
~~\$11~~ Premium
 10,000 x \$1
\$10,000

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Mergers and Acquisitions

EFFICIENT MARKET HYPOTHESIS

EFFICIENT MARKET HYPOTHESIS (EMH) is a financial theory that says the asset (or security) prices reflect all the available information or data.

EXPLANATION OF EMH

- Theory says that stock trades at fair value all times.
- EMH suggests that it is impossible to find undervalued stocks or sell it at premium.
- It suggests that fundamental or technical analyses are not useful under EMH.

WEAK FORM OF EMH
It assumes that stock price includes all information publicly available, but not the information that is not publicly available.

ASSUMPTIONS OF THEORY

- Investors act Rationally & Normal.
- Relevant info is available freely.

CRITICISMS OF EHM

- Warren Buffett, Paul Tudor Jones, John Templeton, and Peter Lynch have always beaten the market returns in long run.
- Those against EMH say that a few financial events could push the stock away from their fair value in a single day.

STRONG FORM EMH
It assumes that both public and private information is priced into the stock price. Private info is available to insiders

FORMS OF EFFICIENT MARKET HYPOTHESIS

SEMI-STRONG EMH
This form gives no importance to both technical and fundamental analysis

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Mergers and Acquisitions

CASE STUDY

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Mergers and Acquisitions

Canadian Pacific Railway Limited

CPR

- Formed in - Late 19th century
- Purpose - To connect major cities in eastern Canada
- Position - Canada's 2nd largest Railroad operating in North America
- Employees - 13,700
- Track - 12,500 miles of track in Canada, Mid Western and North Eastern parts of US.
- Income - \$ 1.3 Billion on operating revenue of \$ 5.7 Billion in 2014.
- Canadian Pacific is considerably smaller than Norfolk Southern.




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Mergers and Acquisitions

Canadian Pacific Railway Limited



Hunter Harrison, CEO

- A long-term railroad executive.
- Retired as the CEO of Canadian National (CN) in 2009.
- Believed consolidation was a good way to add critical rail capacity and simultaneously improve efficiency.
- Under his leadership, CP's operating ratio had fallen from 81% in 2011 to close to 60% in 2015.
- CP's share price during his tenure had soared from less than \$68 at the end of 2011 to almost \$215 in October 2014.




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Mergers and Acquisitions

Norfolk Southern Corporation

- Formed in - 1982
- Formed by - Merger of Norfolk & Western and Southern Railway
- Position - 4th Largest Class I Railroad operating in North America
- Employees - 30,456
- Track - 20,000 miles in 22 Eastern States, and served all major East coast ports.
- Income - \$ 2 Billion of income on operating revenue of \$ 11.6 Billion in 2014.




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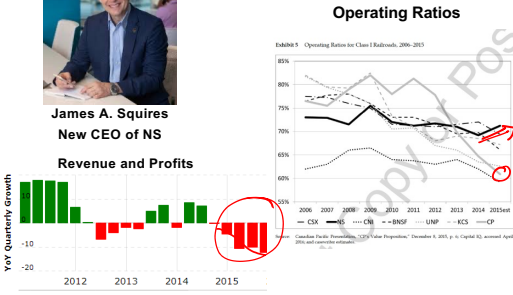
Mergers and Acquisitions

Norfolk Southern Corporation



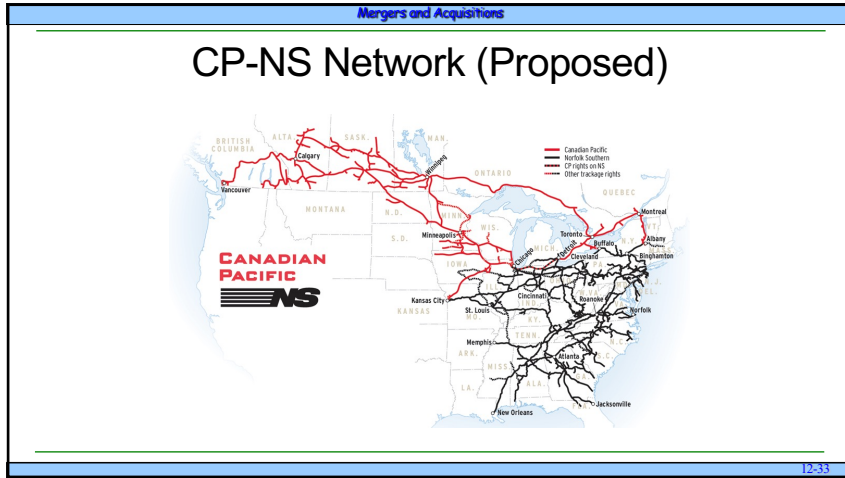
**James A. Squires
New CEO of NS**

- Became CEO of NS on June 1, 2015, at the age of 53.
- Had joined the company in 1992.
- He rose through the ranks of the legal division before being named senior vice president of financial planning in 2006, CFO in 2007, and then president in 2013.



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Event Timeline

1. Merger Rumours

While there were rumours of a possible bid for CP's acquisition with NS, there was an increase in stock prices of both the companies.

NS Stock Price					CP Stock Price			
Shares Outstanding: 301 Mn					Shares Outstanding: 161 Mn			
Beg	End	Change	% Change		Beg	End	Change	% Change
79.87	88.62	8.75	11.00%		134.31	142.18	7.87	5.90%

Handwritten notes:
 Target: Change: \$ 8.75, Share: 301 mn, Δ: \$ 2.633 bn.
 Acq: Change: \$ 7.87, Share: 161 mn, Δ: \$ 1.267 bn.
 Total: Target + Acq = \$ 3.900 bn. (2.633 / 3.9)

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Event Timeline

2. Initial CP offer to NS

- Acquisition for \$46.72 in cash at fixed exchange ratio of 0.348 CP shares for each NS share.
- Offer worth: \$94.95 per NS share
- Acquisition premium = 9%

Handwritten calculations:
 94.95 / 0.348 = 272.84
 272.84 - 46.72 = 226.12 (premium)
 226.12 / 9% = 2512.44 (total value)
 2512.44 - 226.12 = 2286.32 (offer value)
 2286.32 / 0.348 = 6569.88 (CP shares)
 6569.88 * 138.58 = 910.00 (CP value)
 910.00 - 2286.32 = -1376.32 (CP loss)
 138.58 * 0.348 = 48.22 (CP shares for NS)
 48.22 * 138.58 = 6682.00 (CP value)
 6682.00 - 46.72 = 6635.28 (offer value)
 6635.28 / 0.348 = 19067.18 (CP shares)
 19067.18 * 138.58 = 26400.00 (CP value)
 26400.00 - 6635.28 = 19764.72 (offer value)
 19764.72 / 0.348 = 56795.18 (CP shares)
 56795.18 * 138.58 = 78600.00 (CP value)
 78600.00 - 19764.72 = 58835.28 (offer value)
 58835.28 / 0.348 = 169067.18 (CP shares)
 169067.18 * 138.58 = 234000.00 (CP value)
 234000.00 - 58835.28 = 175164.72 (offer value)
 175164.72 / 0.348 = 503347.18 (CP shares)
 503347.18 * 138.58 = 696000.00 (CP value)
 696000.00 - 175164.72 = 520835.28 (offer value)
 520835.28 / 0.348 = 1496654.72 (CP shares)
 1496654.72 * 138.58 = 2070000.00 (CP value)
 2070000.00 - 520835.28 = 1549164.72 (offer value)
 1549164.72 / 0.348 = 4451621.72 (CP shares)
 4451621.72 * 138.58 = 6160000.00 (CP value)
 6160000.00 - 1549164.72 = 4610835.28 (offer value)
 4610835.28 / 0.348 = 13249527.18 (CP shares)
 13249527.18 * 138.58 = 18340000.00 (CP value)
 18340000.00 - 4610835.28 = 13729164.72 (offer value)
 13729164.72 / 0.348 = 39451621.72 (CP shares)
 39451621.72 * 138.58 = 54600000.00 (CP value)
 54600000.00 - 13729164.72 = 40870835.28 (offer value)
 40870835.28 / 0.348 = 117445162.18 (CP shares)
 117445162.18 * 138.58 = 162600000.00 (CP value)
 162600000.00 - 40870835.28 = 121729164.72 (offer value)
 121729164.72 / 0.348 = 349795162.18 (CP shares)
 349795162.18 * 138.58 = 484000000.00 (CP value)
 484000000.00 - 121729164.72 = 362270835.28 (offer value)
 362270835.28 / 0.348 = 1041000000.00 (CP shares)
 1041000000.00 * 138.58 = 1446000000.00 (CP value)
 1446000000.00 - 362270835.28 = 1083729164.72 (offer value)
 1083729164.72 / 0.348 = 3114162172.18 (CP shares)
 3114162172.18 * 138.58 = 4310000000.00 (CP value)
 4310000000.00 - 1083729164.72 = 3226270835.28 (offer value)
 3226270835.28 / 0.348 = 9271162172.18 (CP shares)
 9271162172.18 * 138.58 = 12840000000.00 (CP value)
 12840000000.00 - 3226270835.28 = 9613729164.72 (offer value)
 9613729164.72 / 0.348 = 27625162172.18 (CP shares)
 27625162172.18 * 138.58 = 38200000000.00 (CP value)
 38200000000.00 - 9613729164.72 = 28586270835.28 (offer value)
 28586270835.28 / 0.348 = 82144516217.22 (CP shares)
 82144516217.22 * 138.58 = 113800000000.00 (CP value)
 113800000000.00 - 28586270835.28 = 85213729164.72 (offer value)
 85213729164.72 / 0.348 = 244864516217.22 (CP shares)
 244864516217.22 * 138.58 = 338000000000.00 (CP value)
 338000000000.00 - 85213729164.72 = 252786270835.28 (offer value)
 252786270835.28 / 0.348 = 726400000000.00 (CP shares)
 726400000000.00 * 138.58 = 1006000000000.00 (CP value)
 1006000000000.00 - 252786270835.28 = 753213729164.72 (offer value)
 753213729164.72 / 0.348 = 2164451621722.18 (CP shares)
 2164451621722.18 * 138.58 = 2986000000000.00 (CP value)
 2986000000000.00 - 753213729164.72 = 2232786270835.28 (offer value)
 2232786270835.28 / 0.348 = 6416451621722.18 (CP shares)
 6416451621722.18 * 138.58 = 8880000000000.00 (CP value)
 8880000000000.00 - 2232786270835.28 = 6647213729164.72 (offer value)
 6647213729164.72 / 0.348 = 19100000000000.00 (CP shares)
 19100000000000.00 * 138.58 = 26360000000000.00 (CP value)
 26360000000000.00 - 6647213729164.72 = 19712786270835.28 (offer value)
 19712786270835.28 / 0.348 = 56644516217222.18 (CP shares)
 56644516217222.18 * 138.58 = 78400000000000.00 (CP value)
 78400000000000.00 - 19712786270835.28 = 58687213729164.72 (offer value)
 58687213729164.72 / 0.348 = 168644516217222.18 (CP shares)
 168644516217222.18 * 138.58 = 233000000000000.00 (CP value)
 233000000000000.00 - 58687213729164.72 = 174112786270835.28 (offer value)
 174112786270835.28 / 0.348 = 497445162172222.18 (CP shares)
 497445162172222.18 * 138.58 = 688000000000000.00 (CP value)
 688000000000000.00 - 174112786270835.28 = 513887213729164.72 (offer value)
 513887213729164.72 / 0.348 = 1476645162172222.18 (CP shares)
 1476645162172222.18 * 138.58 = 2046000000000000.00 (CP value)
 2046000000000000.00 - 513887213729164.72 = 1532112786270835.28 (offer value)
 1532112786270835.28 / 0.348 = 4374451621722222.18 (CP shares)
 4374451621722222.18 * 138.58 = 6040000000000000.00 (CP value)
 6040000000000000.00 - 1532112786270835.28 = 4507887213729164.72 (offer value)
 4507887213729164.72 / 0.348 = 12954451621722222.18 (CP shares)
 12954451621722222.18 * 138.58 = 17960000000000000.00 (CP value)
 17960000000000000.00 - 4507887213729164.72 = 13452112786270835.28 (offer value)
 13452112786270835.28 / 0.348 = 38664451621722222.18 (CP shares)
 38664451621722222.18 * 138.58 = 53400000000000000.00 (CP value)
 53400000000000000.00 - 13452112786270835.28 = 40047887213729164.72 (offer value)
 40047887213729164.72 / 0.348 = 115094451621722222.18 (CP shares)
 115094451621722222.18 * 138.58 = 159600000000000000.00 (CP value)
 159600000000000000.00 - 40047887213729164.72 = 1155952112786270835.28 (offer value)
 1155952112786270835.28 / 0.348 = 332164451621722222.18 (CP shares)
 332164451621722222.18 * 138.58 = 459600000000000000.00 (CP value)
 459600000000000000.00 - 1155952112786270835.28 = 1480406887213729164.72 (offer value)
 1480406887213729164.72 / 0.348 = 4254000000000000000.00 (CP shares)
 4254000000000000000.00 * 138.58 = 5886000000000000000.00 (CP value)
 5886000000000000000.00 - 1480406887213729164.72 = 4437993112786270835.28 (offer value)
 4437993112786270835.28 / 0.348 = 12752827862172222222.18 (CP shares)
 12752827862172222222.18 * 138.58 = 17560000000000000000.00 (CP value)
 17560000000000000000.00 - 4437993112786270835.28 = 13122006887213729164.72 (offer value)
 13122006887213729164.72 / 0.348 = 37709786217222222222.18 (CP shares)
 37709786217222222222.18 * 138.58 = 52160000000000000000.00 (CP value)
 52160000000000000000.00 - 13122006887213729164.72 = 39047993112786270835.28 (offer value)
 39047993112786270835.28 / 0.348 = 112206278621722222222.18 (CP shares)
 112206278621722222222.18 * 138.58 = 155600000000000000000.00 (CP value)
 155600000000000000000.00 - 39047993112786270835.28 = 121695206887213729164.72 (offer value)
 121695206887213729164.72 / 0.348 = 349697862172222222222.18 (CP shares)
 349697862172222222222.18 * 138.58 = 484000000000000000000.00 (CP value)
 484000000000000000000.00 - 121695206887213729164.72 = 37183047993112786270835.28 (offer value)
 37183047993112786270835.28 / 0.348 = 1068462786217222222222.18 (CP shares)
 1068462786217222222222.18 * 138.58 = 1476000000000000000000.00 (CP value)
 1476000000000000000000.00 - 37183047993112786270835.28 = 143881695206887213729164.72 (offer value)
 143881695206887213729164.72 / 0.348 = 4134516217222222222222.18 (CP shares)
 4134516217222222222222.18 * 138.58 = 5716000000000000000000.00 (CP value)
 5716000000000000000000.00 - 143881695206887213729164.72 = 55721183047993112786270835.28 (offer value)
 55721183047993112786270835.28 / 0.348 = 15983162172222222222222.18 (CP shares)
 15983162172222222222222.18 * 138.58 = 22060000000000000000000.00 (CP value)
 22060000000000000000000.00 - 55721183047993112786270835.28 = 16487881695206887213729164.72 (offer value)
 16487881695206887213729164.72 / 0.348 = 47381621722222222222222.18 (CP shares)
 47381621722222222222222.18 * 138.58 = 65600000000000000000000.00 (CP value)
 65600000000000000000000.00 - 16487881695206887213729164.72 = 148390931695206887213729164.72 (offer value)
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 590000000000000000000000.00 - 148390931695206887213729164.72 = 14690683781695206887213729164.72 (offer value)
 14690683781695206887213729164.72 / 0.348 = 4221462172222222222222222.18 (CP shares)
 4221462172222222222222222.18 * 138.58 = 5840000000000000000000000.00 (CP value)
 5840000000000000000000000.00 - 14690683781695206887213729164.72 = 145437749031695206887213729164.72 (offer value)
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 414066217222222222222222222.18 * 138.58 = 574000000000000000000000000.00 (CP value)
 574000000000000000000000000.00 - 1440833706831695206887213729164.72 = 1426425369731695206887213729164.72 (offer value)
 1426425369731695206887213729164.72 / 0.348 = 4100662172222222222222222222.18 (CP shares)
 4100662172222222222222222222.18 * 138.58 = 5680000000000000000000000000.00 (CP value)
 5680000000000000000000000000.00 - 1426425369731695206887213729164.72 = 1412060616031695206887213729164.72 (offer value)
 1412060616031695206887213729164.72 / 0.348 = 40606621722222222222222222222.18 (CP shares)
 40606621722222222222222222222.18 * 138.58 = 56200000000000000000000000000.00 (CP value)
 56200000000000000000000000000.00 - 1412060616031695206887213729164.72 = 140265400931695206887213729164.72 (offer value)
 140265400931695206887213729164.72 / 0.348 = 402066217222222222222222222222.18 (CP shares)
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 139828740261695206887213729164.72 / 0.348 = 4010662172222222222222222222222.18 (CP shares)
 4010662172222222222222222222222.18 * 138.58 = 5540000000000000000000000000000.00 (CP value)
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 139828740261695206887213729164.72 / 0.348 = 4010662172222222222222222222222.18 (

Mergers and Acquisitions

Target:
 Change: - \$ 5.20
 Shares: 301
 Δ : - \$ 1.56 bn
 + \$ 3.97 bn
 = \$ 2.41 bn.

Acq:
 Change: - \$ 4.35
 Shares: 161 mn
 Δ : - \$ 0.7 bn
 + \$ 1.53 bn
 = \$ 0.83 bn.

\$ 2.41 bn 74%
 \$ 0.8 bn 26%
 \$ 3.24 bn

Event Timeline

4. Revised acquisition offer by CP

- \$32.86 in cash and at a fixed exchange ratio of 0.451 CP shares for each NS share
- Offer worth= \$91.70 per NS share

NS Stock Price				CP Stock Price			
Shares Outstanding: 301 Mn				Shares Outstanding: 161 Mn			
Beg	End	Change	% Change	Beg	End	Change	% Change
91.52	86.32	-5.20	-5.68%	130.48	126.13	-4.35	-3.33%

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Mergers and Acquisitions

Summary

- M&A activity is a mode of entry for vertical integration and diversification strategies.
- A firm's M&A strategy should satisfy the logic of corporate level strategy.
- M&A activity can create economic value at announcement, but target firms usually capture that value.
- M&A activity can create value over the long term for the acquiring firm.

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