

# Mergers and Takeovers

Specification requirement—

Reasons for mergers/takeovers.

Types of merger with reference to UK industries/markets. Hostile and friendly takeovers. Private equity buy-outs. Management buy-outs (MBOs), Management buy-ins (MBIs) and demergers.

## Takeovers

A Takeover is the acquisition of one business or company by another, either on an agreed or hostile basis. The susceptibility of a company to takeover depends on who controls the majority of shares in issue and which shares have the voting rights, the value of the shares, and the performance of the firm. Often take-overs in certain industries come into fashion, and then there is a huge upsurge in take-over activity in that particular industry.

## Mergers

A Merger is the process by which two companies become one. If the companies are listed, the merger may be by agreement, or hostile. A hostile bid is one in which the directors of the target company reject the approach, but it is still possible for the predator company to obtain control if enough of the target's shareholders accept its offer. This sounds more like a takeover—and it is in all but in name. Mostly mergers are agreed, and once accepted by owners there are less difficult rules of timescale to meet than under conditions of a takeover.

## Reasons For Mergers And Takeovers.

Mergers and takeovers have been a part of the business world for centuries, They allow businesses to grow rapidly and can remove competition from the market. In most cases, by using mergers and acquisitions, a company can develop a competitive advantage and ultimately increase shareholder value. Other reasons for mergers and takeovers include;

- Access to new markets—especially overseas.
- Acquiring new products and technology—a takeover is one way of acquiring technology that may be protected by patent, or may be expensive r time consuming to develop internally.
- Economies of scale are derived from becoming larger.
- Synergy -the idea that  $2+2=5$ . The synergy argument is, that by combining two firms, total profits can be increased by reducing duplicated services such as head office costs, or the two firms fit together in a way that allows costs to be reduced and profits increased e.g. Grand Met and Guinness.
- Cost Savings -Takeovers are often followed by significant numbers of redundancies in the short term. In order to convince shareholders that a takeover is in their interests, managers in the bidding firm often promise that cost savings will result from the merger, and shedding staff is a principal way in which this is achieved. Currently, this pattern of cost savings through redundancies is most evident in the financial

sector where a wave of forced mergers and takeovers are associated with large-scale job losses.

- Underperforming management teams can be removed giving an immediate boost to performance.
- Increased investment is available
- Higher returns to shareholders
- Improved prospects for employees' pay and security.

These arguments for takeovers have in the past been generally accepted, but this view is now being questioned. Recent research shows that the profitability of firms that are taken over is no better than other quoted companies. This suggests that takeovers are not the best way to correct managerial failure. Even more importantly, the performance of merged companies frequently fails to deliver the expected benefits and, indeed, worse performance more commonly results: one study found that "acquisitions have a systematic detrimental impact on company performance. Also as post-merger company performance suffers, a likely outcome is a reduction in job security in the long term".

### Wider effects of takeovers

As well as the direct effects on ownership, takeovers can have a more general impact on company performance and employment. Senior managers in firms potentially the subject of a hostile takeover see this as a threat because takeovers generally result in a change of executives. Thus management behaviour can be determined by attempts to prevent the firm being taken over. This can be achieved through con-

centrating on maximising short-term profitability in order to keep up the share price - making a hostile bid more expensive - and through distributing a high proportion of profits in the form of dividends to shareholders in order to generate loyalty to the existing managerial team. Therefore a major effect of the threat of take-over is the focus of management towards short-term goals, at the expense of investments in research and development, new technology and training.

### Private equity buy-outs.

Private equity describes how investment companies raise the funds they use. Private equity companies raise cash from private sources and then leverage (raise money on top of this) this by borrowing from banks.

They then use this money to buy companies that they have identified as underperforming, but with the potential to do far better. Many of the firms they buy are listed on the stock market, but are then de-listed, but may return to the stock market at a later date when sold on. Private equity companies usually look for a profitable sale within the medium term - say three to six years.

After a take-over it is normal for the private equity owners to bring in new management teams to turn the taken over company around.

The private equity firms not have to keep shareholders happy in the same way as PLCs do, so private equity firms argue that the companies they control are more able to

make difficult or long-term decisions. It is therefore easier to develop a long term strategy to rebuild a business, than if institutional shareholders were putting the company under short term pressure. So private equity firms have the capability to build a successful company from a failing one.

There is also an argument that companies taken over by private equity firms have the ability to create jobs quickly and contribute to growth in the economy.

The downside of private equity firms.

There are though of course counter arguments.

- Lost tax revenue—because firms taken over by private equity companies are often burdened with debts ( the borrowing from banks used to fund the take over) profits will be lower - so less tax is paid to the treasury.
- Jobs are lost—the AA and Birds Eye were bought out and subsequently the new private equity owners oversaw hundreds of redundancies in both firms
- Asset stripping—one of the main criticisms of private equity is that they "asset-strip" - sacking people and selling off property and non core assets, trying to pay back the finance they raised to fund their deals.

In recent months (early 2009) private equity firms have been very active in taking over companies that have become insolvent. There are two views on this activity, firstly they are saving jobs and even industries or secondly they are buying cheap the victims of the recession.

## Management buy-outs (MBO)

A MBO takes place when a group of managers buys the business they work for from its existing owners.

The funding for the MBO may come from outside the business, such as from bankers or venture capitalists, or it may at least partly funded by redundancy payments if the current owners are closing the business. Investment by the management team is therefore one of the key features of MBOs

The amount the management will invest varies from deal to deal. External investors expect that it is a material amount, which means that it represents a considerable personal commitment by the management team, but need not be a huge relative to the total cost of the buy-out.

For example, a five-strong team buying an electronics company may be able to put together £30,000 each - this £120,000 total may not seem much when set against the balance of the purchase price, say £2m put up by venture capitalists or a bank, but it does help the external investors feel confident that the new directors are committed to making the business a success.

Why do MBOs happen?

One of the main reasons why many managers take the plunge and mount an MBO is because the existing owners see the particular part of the business they work in as no longer core to the whole company. As a result they could be planning to sell it or even close it. The management may therefore be presented with a choice, buy the business or lose their jobs.

Other companies that are in financial difficulties decide that they wish to focus on core activities and retrench, as a result they want to sell off assets to raise cash in and to prevent financial ruin. These firms may be much more open to MBO offers than they would normally be.

Many MBOs follow a takeover or a merger – a company may buy another business and then find that not all of what it now owns is relevant to its future strategy. In this type of circumstance it may offer the managers of that particular part of the firm the opportunity to buy the business.

Another typical circumstance that is suitable for a MBO, is when in family-run businesses, existing owners may not have any children interested in or capable of taking over the business. In these circumstances, they may be keen to ensure continuity of the business, protecting employment and rewarding those that have helped build the firm by allowing them to buy the firm.

Managers involved in MBOs often say they took the risk because it empowered them, giving them the opportunity to make a real impact on the business, to be able to correct inefficiencies, direct strategy and decide what the business was going to do. Also of course the new owners can potentially make a great deal of money from their venture.

For long term success a MBO needs a number of important factors to be in place.

- There needs to be enough finance available not just for the buy out, but perhaps also for working capital and

restructuring.

- The price paid has to allow a decent return on the capital invested.
- The team of managers needs to have a spread of skills and talents. Apart from the skills and knowledge that the senior management team will have acquired from their business experience, the business needs someone who understand cash flow and management accounts. Also the firm will need someone who is able to define objectives and develop a successful strategy
- The business must be viable, be capable of being improved, winning new custom and contracts, becoming more efficient. It does not necessarily have to be immediately profitable but it does have to be capable of achieving profits.

### Management buy-ins (MBIs).

Management Buy-in or MBI is the purchase of a business by a team of managers from outside of the business who have financial backers ( often private equity funding) and plan to manage the business actively themselves.

Usually, the team will be led by a manager with significant experience at managing director level. Teams ready for a MBI firstly have to identify a target business, one that's located in the right place, is in an industrial sector that the MBI team understand, is operating in a high-growth market and that is affordable.

Why MBIs can succeed.

- The change is desirable for all stakeholders if the company is not managed well by the existing management team.

- The new management are likely to be well funded, therefore being able to provide investment for change
- The new management are likely to have relevant industry experience, and contacts that can lead to an increase in business for the firm.

## Notes

### Why MBIs can fail

- The new management do not know the firm, there may be a steep learning curve to overcome
- There can be a clash of cultures between the new management and existing employees
- The level of borrowing to fund the buy-in can put financial pressures on the business
- Existing management will be demotivated during the buy in process, leading to higher staff turnover and potentially a loss of experience which can be crucial to the firms success,

### Demergers.

When a demerger occurs a company divides up (demerges) its business and sets up the demerged parts as a completely separate company or companies.

When a PLC demerges, shareholders will end up holding shares in the new companies as well as what remains of the existing firm.

A demerger allows management to concentrate on the core business, reducing levels of hierarchy and reducing dis-economies of scale. Also demergers can have the effect of increasing the value of the total business as the sum of the demerged parts ends up being more highly valued by the stock market than the original firm.