Università Cattaneo

COMPANY'S INTERNAL AND EXTERNAL GROWTH – THE M&A MARKET & AN EXERCISE ON VALUATION

Lesson 12

Corporate Finance

Castellanza, 3rd December 2018

SUMMARY

- Internal growth vs external growth
- Mergers and acquisitions: some preliminary concepts
- Acquisitions
- Reasons to acquire
- Mergers
- Investors and transaction techniques
- Leveraged buy-out
- Capital increase
- Demergers

EXTERNAL GROWTH VS INTERNAL GROWTH

- INTERNAL GROWTH ⇒
  - Investments in plants, equipments
  - Investments in technologies
  - Investments in human resources

- EXTERNAL GROWTH ⇒
  - Mergers and acquisitions
  - Other transactions, such as alliances, joint ventures etc.

MERGERS AND ACQUISITIONS:
SOME PRELIMINARY CONCEPTS

- Mergers & Acquisitions (M&A) refer to the aspect of corporate finance dealing with those monetary decisions that imply significant changes in the company’s life.
- In particular, M&A transactions deal with the buying (acquisitions), selling (sell-offs), dividing (split-offs and demergers) and combining (mergers) of different companies and similar entities.
- This kind of transactions have a deep impact on both the development and the expansion of the company.

ACQUISITIONS

- An acquisition is a corporate action in which a company buys most, if not all, of the target company's ownership stakes in order to <u>assume control</u> of the target firm.

Reasons to acquire

- Entrepreneur's ambition
- To increase revenues and market share
- To enter in a new market, in a new industry
- To enter in a new geographical area
- To obtain a royalty, know-how, trade mark
- To eliminate a competitor
- Diversification (risk/product/industry)
- Economies of scale and vertical integration
- To gain a key supplier/client

Acquisitions

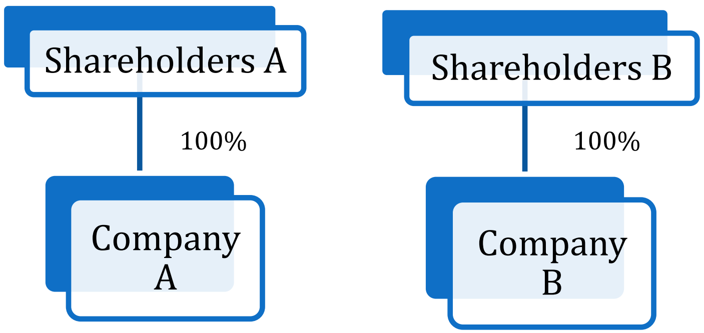
- The target co. can:

  - Remain an INDIPENDENT LEGAL ENTITY.
  - <u>The acquisition may be performed through:</u>
    - <u>cash</u>
    - <u>contribution of shares</u>

  - Be <u>MERGED</u> >> the two companies are combined to form a SINGLE LEGAL ENTITY

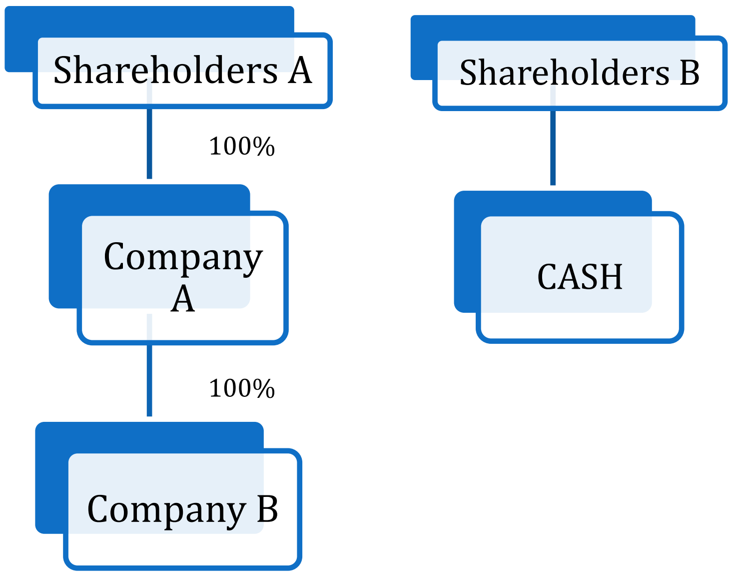
ACQUISITION FOR CASH

Prior to the transaction:



ACQUISITION FOR CASH

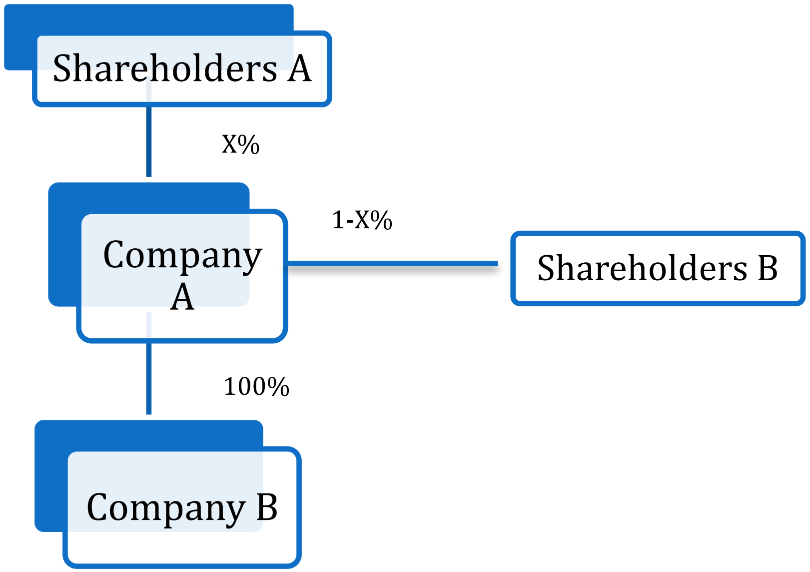
“A” acquires “B” <u>for cash:</u>



“A” buys “B” – “A”’s entity remains unchanged

CONTRIBUTION OF SHARES

"A" issues shares in exchange for "B" shares:

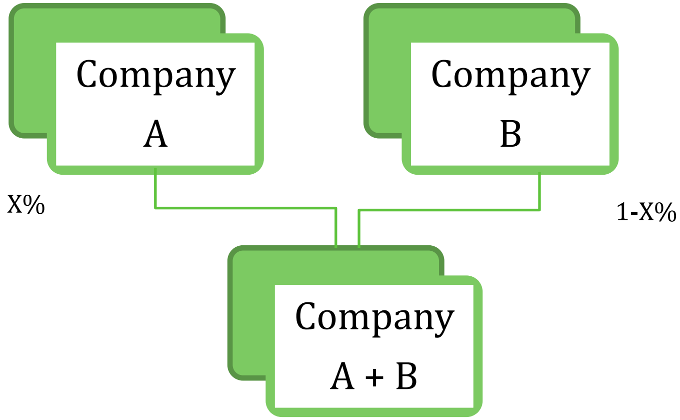


"A"'s equity rises by an amount equal to the value of "B"'s equity, but "B" continues to exist

MERGERS

- If two companies merge, the shareholders of the acquired company become shareholders of the acquiring company and the acquired company ceases to exist as a separate legal entity.

"A" and "B" merge:



Mergers and acquisitions

Economically speaking, there is NO difference between the previous transactions.

⇩

The group created by bringing together "A" and "B" is economically identical regardless of how the business combination is effected.

INVESTORS AND TRANSACTION TECHNIQUES

FINANCIAL INVESTOR

- LEVERAGED BUY-OUT
- EXPANSION CAPITAL

Other COMPANIES

- BUY-OUT:
  - Cash
  - Exchange of stocks
- CAPITAL INCREASE
- MERGER

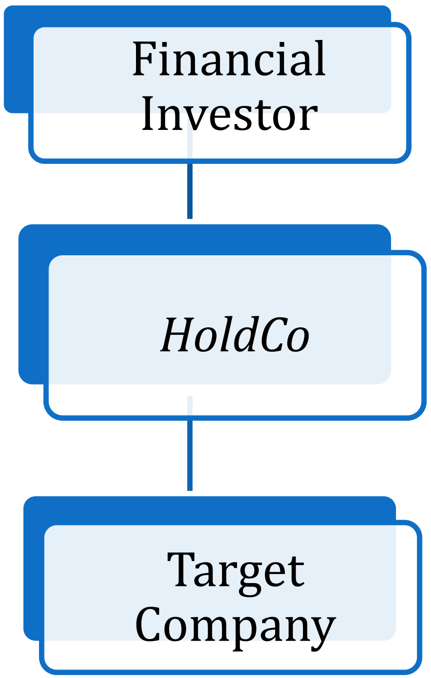
MANAGERS

- MANAGEMENT BUY-OUT

LEVERAGED BUY-OUT

- LBOs are a form of corporate acquisition that allows to make large acquisitions without having to commit a lot of capital.
- A holding company (*HoldCo)* is created to borrow money to buy another company (the target company). The debt is secured by the assets of the target company.
- The *HoldCo* and the Target will be merged; therefore the *HoldCo* will pay interest on its debt and pay back the principal from the cash flows generated by the target.

LEVERAGED BUY-OUT



- Assuming that the Enterprise Value of the Target is Euro 500.000, an *HoldCo* is created to buy the Target company, financing the purchase with Euro 300.000 in equity and Euro 200.000 in debt.
- We assume that the cost of debt is 7%.

Leveraged buy-out

Target Balance Sheet

Assets	Shareholders Equity
€ 500.000	€ 500.000

HoldCo Balance Sheet

Shares of the Target Co.	Debt
€ 500.000	€ 200.000
	Shareholders Equity
	€ 300.000

Ratio

Debt	40%
Equity	60%

Merger

HoldCo and Target

Assets	Equity
€ 500.000	€ 300.000
	Debt
	€ 200.000

LEVERAGED BUY-OUT

- <u>Leverage ratio</u>

- The equity portion of the acquisition financing shrinks.
- The risk of financial distress increases.

MANAGEMENT BUY-OUT

- A Management buy-out is a transaction undertaken by the existing management;
- If the managers set up an *HoldCo* to borrow money in order to purchase the company from the existing shareholders, the transaction takes the name of Leveraged Management buy-out.

CAPITAL INCREASE

- A capital increase transaction refers to the increase of a company's equity capital through the issue of new shares.
- An investor performing a buy-out transaction purchases the company from the existing shareholders who take the money. Differently, an expansion capital transaction (capital increase) implies that financial resources are put inside the company.

EXPANSION CAPITAL

- A company is willing to develop a new product, but its finances would not allow it. So shareholders decide to attempt to acquire financing from external investors. They calculated the capital requirements at Euro 1.000.000.
- How much of the company the investor should receive for Euro 1.000.000 investment?

Company's equity value (pre-money)	4.000.000
Equity increase	1.000.000
Company's equity value (post-money)	5.000.000

DEMERGERS

- When a company is in financial distress, the affected firm usually faces a shortage of cash flows. Therefore, the company may set in place several techniques in order to generate cash and decrease outflows.
- There are several techniques to divest:
  - Selling of investments/securities;
  - Selling of subsidiaries and/or parts of business;
  - Demergers;
  - Split offs.

DEMERGERS

- A demerger occurs when a group with several divisions decides to <u>separate</u> them into distinct companies throughout the transferring to a beneficiary company, either an existing or a newly-established one. The shareholders of the demerged company hand in the shares held and receive new shares of the demerged company as well as shares of the beneficiary company.

<u>Forms of demerger:</u>

- TOTAL
- PARTIAL

DEMERGERS

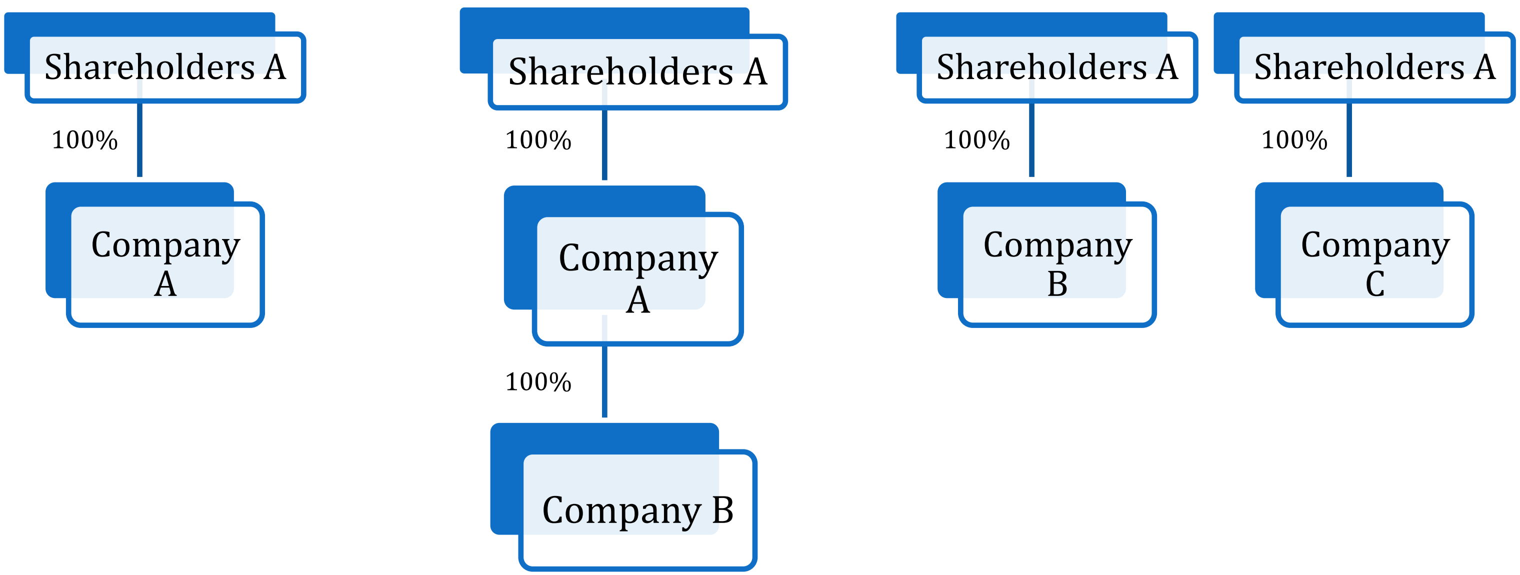
- A demerger can be carried out by spinning off certain net assets and creating a subsidiary company, or by dissolving the original company, creating two/more new companies and distributing the shares to the shareholders in proportion to their original ownership in the firm.

DEMERGERS

Prior to the transaction:

"A" spin-offs a part of its assets and "B" is created

"A" ceases to exist and "B" and "C" are created



EXERCISE – UNLEVERED DCF

- Compute the Equity Value of the firm according to the Unlevered Discounted Cash Flow approach.
- Reference date: 2012

k(e)	8%
k(d)	4%
g	1%

INCOME STATEMENT

Profit & Loss				
	2012	*2013*	*2014*	*2015*
Revenues	9.424	10.529	11.661	12.750
Ebitda	**2.286**	**2.674**	**3.134**	**3.573**
Depreciation intangible assets	(31)	(25)	(29)	(30)
Depreciation tangible assets	(1.133)	(1.207)	(1.383)	(1.529)
Ebit	**1.122**	**1.442**	**1.722**	**2.014**
Financial expenses	(212)	(204)	(185)	(155)
Extraordinary expenses	0	0	0	0
Taxes	(357)	(464)	(563)	(666)
Net income/ (loss)	**553**	**774**	**974**	**1.193**

BALANCE SHEET

Balance Sheet				
Assets	*2012*	*2013*	*2014*	*2015*
Intangible assets	129	129	125	120
Tangible assets	1.915	2.178	2.476	2.626
Inventories	1.538	1.639	1.819	1.947
Account receivables	3.110	3.475	3.848	4.207
Other receivables	289	294	301	307
Cash & cash equivalents	353	328	290	226
Total	**7.334**	**8.043**	**8.859**	**9.433**
Liabilities	*2012*	*2013*	*2014*	*2015*
Short term debts	1.283	1.198	1.040	830
Long term debts	2.529	2.406	2.127	1.660
Account payables	1.112	1.216	1.311	1.371
Other payables	629	630	703	712
ETP fund	367	405	517	597
Equity & reserves	861	1.414	2.187	3.070
Profit	553	774	974	1.193
Total	**7.334**	**8.043**	**8.859**	**9.433**