Corporate Finance Solution

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Part A: ***Discuss the motives behind corporate restructuring and evaluate the methods by which mergers and takeovers may take place***.

A.1. Corporate restructuring is defined as

> *"The act of reorganizing the legal, ownership, operational, or other structures of a company for the purpose of making it more profitable, better positioned or better organized to meet its current and future needs."(Norley, Lyndon et al)*

Corporate restructuring is of three types i.e. Portfolio / Asset restructuring, financial restructuring and debt restructuring. However, they are not always mutually exclusive e.g. mergers and spin-offs while essentially portfolio restructuring also lead to some financial restructuring.

The motives behind corporate restructuring are many, and the main ones are listed below:

Creation of Synergies: Synergies may be created due to decreased costs or increased revenues obtained through economies of scope, scale, learning effect etc. It may also be because of gained access to some complementary or limited resources. These synergies can be tapped through mergers e.g. horizontal and vertical integration, joint ventures, alliances, acquisitions. In fact a study done by James, Ryngaert and Houston (2001) on bank mergers showed that markets show a significant relation between expected synergies and announcement date returns, applying a greater discount to the present value of revenue-increasing synergies than to cost-reducing synergies.

Eliminating Inefficiencies: Companies or conglomerates may have business units (BUs) or companies resulting in negative synergies e.g. high overhead costs due to inflexible cost structures, product cannibalisation. They also may have share holder value getting diluted due to siphoning off of earnings from more profitable to less profitable (or loss making) businesses. This can be prevented through corporate restructuring aimed at streamlining or re-focusing on core businesses only resulting in divestitures, sell-offs, liquidations, carve-outs, out-sourcing etc.

Both profitable and unprofitable businesses which do not directly contribute to the core company business can be separated. In both cases, focus on core competencies should create value so long as the marginal costs are higher than the marginal benefits of diversification (Andreas Kemper and Khuen)

Changes in External Environment: The company may need to undergo corporate restructuring in order to survive (or improve its efficiency) as a result of certain market changes

1. *Taxation:* Announcements of specific tax brakes may lead to financial restructuring e.g. allowing more investments in infrastructure or R&D. Alternately, tax increase may lead to higher leverage.
2. *Changes in Political Environment:* E.g. companies may opt for divestiture in countries where inhospitable regimes come to power fearing nationalisation of their assets and operations
3. *Changes in Markets / Economy:* In face of a sluggish economy or crisis like the current global financial crisis, irms may need to restructure finances to survive. This may include scaling down production or even shutting down plants, filing for bankruptcy, cutting work-force, combining departments etc.

On the other hand, companies with rapid growth may find that their original structure cannot efficiently manage the current and future business model. This may lead to restructuring involving spinning off subsidiaries, adopting more efficient financial models etc.

Create Market Power / Dominance: Companies may merge to increase their size and form conglomerates. This could be of value in countries where there is insufficient access to sources of finance and therefore creating an internal capital market (funding cash starved BUs from large revenue BUs) may have a justification. This may also be done to increase political clout, thereby increasing ability to influence regulations. (Michael Blatz et al). However studies by Mueller (1985), and Eckbo (1992) show that efforts to enhance market position through M&A yield no better performance, and sometimes worse.

Utilize Surplus Funds: Sometimes cash rich firm with limited growth opportunities may decide to invest their excess cash in cash-strapped firms. This step runs the risk of value destruction unless the cash is redeployed profitably.

Involuntary Restructuring: So far all the reasons for corporate restructuring discussed have been initiated in the company undergoing restructuring. However, in certain cases companies may be forced to undergo restructuring. This happens when they become the target of a hostile take-over or a leveraged buy-out (LBO).

In addition to the above mentioned motives, corporate restructuring can also be due to specific strategic reasons. However, whatever the underlying motive, restructuring can be deemed a success if it results in one or more of the following - better organisation and bundling of business activities, reduction in complexities, increase in reserves, establishment of a basis for future-focussed growth.

A.2. Many techniques exist for the valuation of mergers and takeovers. These include

1. The Discounted Cash Flow Method
2. Market Multiple Analysis Method
3. Adjusted Book Value Approach
4. Comparable Company Approach

In the past, the adjusted book value method and the comparable company method were usually used for valuation. In the past few years though, it is the discounted cash flow method which has gained popularity and acceptance. This is primarily driven by the fact that it is conceptually superior, being as it is based on projected, future operating results rather than on past operating results.

The discounted cash flow approach to corporate valuation involves four broad steps (Brealey-Myers, 2003):

1. Forecast the free cash flow
2. Compute the cost of the capital
3. Estimate the continuing value
4. Calculate and interpret results

Different methods also exist for financing of mergers and takeovers. These include

Stock Financed Takeovers: Also called ‘all share deals’ they occur instead of paying cash the buyer issues new stock in itself to the company being bought. This happens primarily when a private company takes over a public company.

Cash Financed Takeovers: These deals generally include ‘loan note alternatives’. This allows payments to be done through these ‘loan note’ instruments rather than hard cash, to take advantage of tax shields. This happens because conversion of shares into cash is considered a disposal and this initiates a payment of capital gains tax. This can be compared to the tax getting rolled over when shares are converted into other securities.

Leveraged Buy Outs: These are takeovers financed through debt either by the buyer issuing bonds or by borrowing from a bank. Management Buyouts (MBOs) differ from LBOs only in that the buyers are the managers of the company.

Evaluating, the various financing options leads to the evidence from studies showing that stock based deals are associated with significantly negative returns at deal announcements, whereas cash deals are zero or slightly positive. (Bruner and Mullins 1987, Travlos 1987, Huang and Walkling 1987 and Yook 2000) This is in accordance with theory which suggests that issuance of stock options is perceived by markets as a signal that management believes that the shares are overpriced.

LBO's differ from normal takeovers in that it is heavily financed by debt. Three key features of LBOs are (Milton L. Rock, Robert H. Rock, Martin J. Sikora):

1. *High Debt*: Though almost completely financed through debt, LBOs do not lead to long term debt since they are designed for the debt to generate cash that can be used to enable pay back over a short duration.
2. *Incentives*: Managers generally receive a larger stake in the business through direct ownership of shares or stock options.

3. *Private ownership*: LBOs are removed from public ownership. They are owned by partnerships comprised of private investors. Though not permanent, private ownership enables, close monitoring of performance and quick action where needed.

Giving higher equity stakes to managers increases the probability of success of LBOs compared to other takeovers. In fact studies conducted reveal that when managers have a stake, greater value is generated for the firm. (Healey, Palepu and Ruback, 1997) The most successful LBOs are those that go public again, once improvements in operating performance have been proved and the high debt has been paid down substantially.

In fact the initiation of mergers and takeover, is associated with a creation of serious additional value for the buyers and hence leads to significant increases in stock price (Schipper and Thompson, 1983) and (Gregory 1997)

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