



N P T E L O N L I N E C E R T I F I C A T I O N C O U R S E S

MERGERS, ACQUISITIONS AND CORPORATE RESTRUCTURING

PROF. CHANDRA SEKHAR MISHRA

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Indian Institute of Technology Kharagpur**

LECTURE: 6

**TITLE: Takeover Tactics and Anti-
takeover Defenses – 1**

- **Introduction to Takeover tactics and defenses**
- **Friendly vs Hostile Approaches of Takeover**
- **Different Takeover tactics**



Keywords



- Takeover tactics
- Defense tactics
- Bear hugs
- Street sweeps
- Godfather offer
- Proxy contest

Few Facts about Takeover Tactics and Defenses*

- There is a widespread use of defensive tactics.
- Tactics derive their power by influencing speed of closure, costs to the buyer, and perceptions about uncertainty to the investor.
- Defenses are control options
- Whether defensive tactics create or destroy value for target shareholders depends on governance and uncertainty.
- A high offering bid is the most persuasive attack. A high stock price is the best defense.

** Adapted from Bruner, R. F. (2004)*

Basic Features of Attacks and Defenses*

- Defense tactics seek to delay the outcome and increase uncertainty about whether the target will be sold, and if so, at what price. Defense tactics discourage Arbitrageurs, who hate delays and uncertainty.
- Attack tactics seek to accelerate the outcome and resolve uncertainty. These tactics serve the interest of arbitrageurs and thereby improve the fluidity in the exchange of votes.

** Adapted from Bruner, R. F. (2004)*

Basic Features of Attacks and Defenses, contd..*

- Defenses are control options.
- Defenses will be more valuable *longer the delay, and the greater the uncertainty* about the value of the underlying asset (i.e. the enterprise). (Related to financial options!)
- Tactics of attack aim to negate defenses and thereby destroy the option value that the defenses create.

* Adapted from Bruner, R. F. (2004)

Basic Features of Attacks and Defenses, contd..

- Managers try to drive away hostile bidders for the hostile take over attempts made by them.
- Defense tactics can be implemented before, during or after the takeover attempt/ offer.
- Intensity of takeover varies from mild to very tough
- Defense tactics can take the form of shields created around a company to drive away unwanted offers.
- Takeover defense can also be a shield to get premium offers for the target firm.

Takeover Tactics - Two Different Approaches

- Friendly
- Hostile

Friendly Takeover Approach

- Negotiated settlement
- Informal communication with the target's top management
- Agreement on the key issues early in the process
- Long term business strategy
- Discussion about the key executive positions
- Standstill agreement for at least a certain period of time covered by the agreement
- Permits negotiations without threat of aggressive tactics

Hostile Takeover Approach

- Rejection by target company's board of initial offers
- Try to take control of the target firm
- Adopt more aggressive tactics
- Against the wishes of the management of target company
- Gaining control without consent

Tactics of Takeover Attack

- Purchase of shares directly in the market (it can be pre-tender)
 - Street Sweep
 - Drop and Sweep
 - Block purchase or toehold stake
- Offer directly to the target board of directors
 - Dawn Raid
 - Bear Hug (Offer to management **without** a concurrent public announcement)
 - Strong Bear Hug (Offer to management, **with** a concurrent public announcement)
 - Super Strong Bear Hug (**Two tier** offer to management, **with** concurrent public announcement)
 - Godfather Offer

The Bear Hug examples

- **Elon Musk & Twitter:** On April 14, 2022 Elon Musk made public that he is going to bid to acquire Twitter at a high premium
- Elon Musk made the offer to the Twitter's management to acquire the shares at a very high premium to the current market price [offered \$54.20 per share, 100% stake valued at \$43 billion].
- **Microsoft & Yahoo:** One more example is that when in 2008 Microsoft CEO wrote to the CEO of Yahoo as, "together we can unleash new levels of innovation, delivering enhanced user experiences, breakthroughs in search, and new advertising platform capabilities"
- Then after 24 hours the proposal was made to the public

Tactics of Takeover Attack, contd..

- Tender offer directly to target shareholders
 - One-tiered
 - Two-tiered (Coercive tender offer structures – Prisoner's dilemma)
 - Creeping acquisition/ takeover
- Proxy contest and consent solicitation (like a political campaign)
- Challenge the target's defenses through litigation

Tactics of Takeover Attack, contd..

- **Examples of Bear Hugs**

- **Elon Musk & Twitter:** On April 14, 2022, Elon Musk made public that he is going to bid to acquire Twitter at a high premium
- Elon Musk made the offer to the CEO of Twitter Jack Dorsey to acquire their shares at a very premium price than the current market price
- **Microsoft & Yahoo:** In 2008, Microsoft CEO wrote to the CEO of Yahoo as, “together we can unleash new levels of innovation, delivering enhanced user experiences, breakthroughs in search, and new advertising platform capabilities”.
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Tactics of Takeover Attack, contd..

- To minimize the hold-up problem (discourage the target to back-out)
 - Letter of intent
 - No-shop agreement
 - Breakup fees (Infosys – Axon, 2008: 1% of the acquisition amount; Hindalco – Novelis, 2007: \$100m)
 - New buyer premium (Hindalco - Novelis)



Factors Affecting the Choice of Attack Tactics

- Attitude of target management and board
- Distribution of voting power
- Strength of target defenses in place
- Presence of competing bidders and/or a white knight



Takeover Defense

- Not all mergers are welcome.
- A variety of devices are developed to defend firms from unwelcome takeover proposals.
- Possible motivations for defense
 - Target seeks a better price.
 - Management believes the target would perform better as independent firm.
 - Management is seeking to entrench itself.



Financial Conditions that Make Firms Vulnerable

- Low market to book ratio (Q – ratio)
- Highly liquid balance sheet
- Good cash flow to stock price
- Small percentage owned by incumbent management
- Else, simply the company or part of the company may look like ‘Crown Jewels’!



Financial Defensive Measures

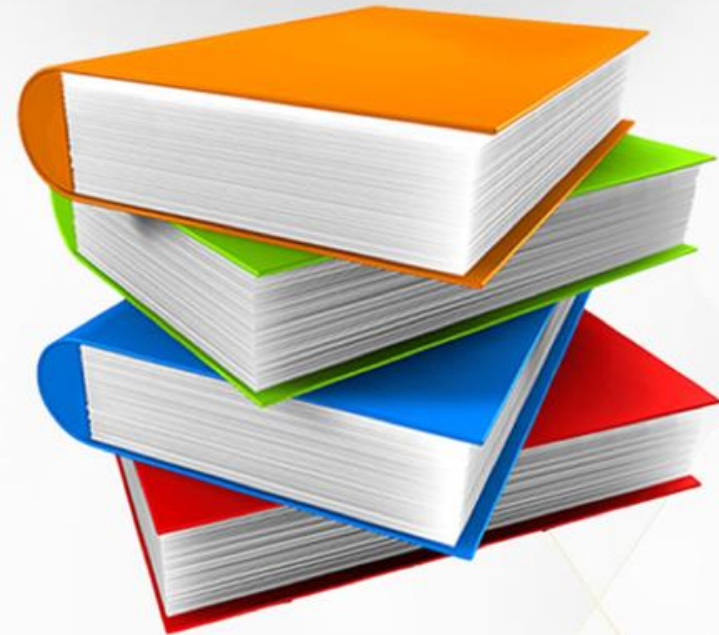
- Increase debt – use funds to repurchase equity
- Increase dividends
- Structure loan covenants to force acceleration of repayment in the event of takeover
- Decrease excess cash
- Use excess liquidity to acquire other firms
- Divest or spin-off units
- Sell undervalued assets
- Increase value by restructuring



CONCLUSION

- Takeover attack and defense techniques common in M&A.
- Both the parties try to get the best deal done and/or act to have control over the target.
- A particular party might use multiple techniques of attack (or defense).

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LECTURE: 7

**TITLE: Takeover Tactics and Anti-
takeover Defenses – 2**

- Takeover Defenses – rationale
- Financial Defenses
- Proactive, Deal-Embedded and Reactive Defenses

eywords



- **Poison Pills**
- **Poison Puts**
- **White Knights**
- **Greenmail**
- **People Pills**
- **Golden Parachute**

Takeover Defense

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- A variety of devices are developed to defend firms from unwelcome takeover proposals.
- Possible motivations for defense
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Financial Conditions that Make Firms Vulnerable to takeover

- Low market to book ratio (Q – ratio)
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- Else, simply the company or part of the company may look like ‘Crown Jewels’!

Financial Defensive Measures

- Increase debt – use funds to repurchase equity
- Increase dividends
- Structure loan covenants to force acceleration of repayment in the event of takeover
- Decrease excess cash (like pay extra dividend to equity shareholders)
- Use excess liquidity to acquire other firms
- Divest or spin-off units
- Sell undervalued assets
- Increase value by restructuring

Tactics of Takeover Defense – Broad Classification

- Proactive Defenses (Before a Hostile Bid)
- Deal-embedded Defenses (Tactics Embedded in a Friendly Deal) to avoid the intruder
- Reactive Defenses (After a Hostile Bid)

Proactive Defenses

- Charter Amendments
 - Classified or Staggered Board
 - Supermajority Provision
 - Fair price provision
 - Dual-class recap
- Poison Pills
- Poison Puts
- Golden Parachute
- ESOPs and labor agreements

Poison Pills

- Securities created to make acquisition of control of target firm prohibitively costly
 - Board can adopt without shareholders' approval
 - Legal precedent requires justification to adopt
- Types of plans
 - Flip-over plans: bargain purchase of bidder's shares at some trigger point.
 - Flip-in plans: bargain purchase of target's shares at some trigger point.
- **Example: Bank of New York bid for Irving Bank (1987)**
 - Irving rejected, adopted flip-in poison pill, but Bank of New York not allowed to participate.
 - Court ruled that the pill was discriminatory.

Poison Pills, contd..

- Dead-hand provisions grant board ability to redeem poison pill only by continuing directors
 - Strengthens board's negotiating position
 - Takeover deterrent
- Chewable poison pills (to keep the pills but make them "chewable" by having shareholders affirm them from time to time. Companies including Disney, Bristol-Meyers-Squibb and CVS have adopted the idea.)
- Some shareholder groups are critical of poison pills since they can be used to prevent takeovers
- Signaling of takeover probability

Poison Puts

- Give bondholders right to put, at par or better, target bonds in event of change in control
 - Protect against risk of takeover-related deterioration of target bonds (from leverage, etc.)
 - Place potentially large cash demands on new owner, raising costs of acquisition
- Economic rationale
 - Entrenchment hypothesis – make firms less attractive as takeover targets
 - Bondholder protection hypothesis – protect bondholders from wealth transfers in debt-financed takeovers

Golden Parachute

- Change in control benefits for top level management
- Severance package in employee's contract
- Key personnel's are protected by this clause whenever there is change in control of the firm
- If there is a loss of job then severance package is paid to them
- The benefits can be paid to them in cash, bonuses or stock options too
- It is paid if the employment is severed prematurely
- Protects interest of employees during hostile or unfavorable environment
- Existing employees can be dominated by the new employers

Golden Parachute contd.

- Ensures exit of employees if there is any unfavorable condition
- No financial loss to the employees
- Key employees do get the benefit but other employees may get left out of the clause
- This severance payment is subject to tax payment all over the world
- No tax deduction to the company
- If there is any pension benefits or welfare benefits in the package it will also attract tax
- Cost estimated to be under 1% of total takeover cost (not enough to be a defense)
- Silver parachutes – provide less generous severance payments to executives
- Tin parachutes – modest severance payments to wider range of managers and employees

Golden Parachute contd..

Rationale

- Implicit contracts: managers' contributions come over long time period, but impractical to write long-term deferred contracts
- Encourage managers to accept changes of control that bring shareholders gains
- Optimal model might tie parachutes to synergy gains in combined firm to avoid misuse (Berkovitch, Khanna, 1991)

Golden Parachute Pros. and Cons.

- Pros:
 - Security
 - Hire and retain
 - Reward for the risk
 - Attracts top talents
 - Avoid hostile takeover
- Cons:
 - Executives can take benefits even at the cost of the company
 - Top executives get the benefit but the lower level employees can loose job
 - over payment may lead to increase in the cost of the company
 - Year's of service are ignored

Golden Parachutes Examples, contd..

- **Google & Motorola:**

- Google acquired Motorola at \$12.5 billion (2011)
- Motorola's CEO was Mr Sanjay Jha whose services were not required anymore by Google.
- Mr Sanjay Jha received a Golden Parachute amounting to \$66million which included cash payment of \$13.20million and the rest amount in stock options and shares

- **Elon Musk & Twitter:**

- Elon Musk took over social networking company Twitter valued at \$44 billion (2022)
- The top three executives of Twitter namely CEO Parag Agrawal, CFO Ned Segal and Legal affairs and policy chief Vijaya Gadde were made to leave Twitter.
- The executives tend to receive the Golden Parachute payments of \$57.4million, \$44.5million and \$20 million respectively for their termination, subject to any other legal issue.

Deal Embedded Defenses

- Breakup or topping fees
- Asset lockups
- Equity lockups
- Toehold stakes

Reactive Tactics (Post bid Defenses)

- Litigation
- Regulatory protection/ Legislative protection
- Counter-tender (Pac-Man Defense)
- Asset restructuring
- White knight / White squire
 - When white knight turns hostile, it is called Lady Macbeth Strategy
 - Other types of Knights: Yellow; Gray;
- Share repurchase (buyback of shares)
- Declaration of extra dividend for equity shareholders

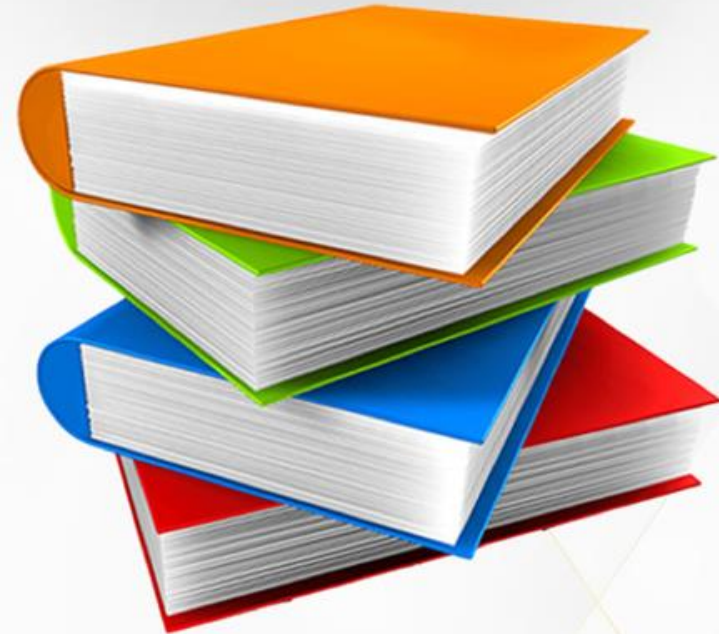
Reactive Tactics (Post bid Defenses) contd..

- Greenmail
- Leveraged recapitalization
- Going private / LBO
- Scorched Earth Policy
- People Pill
- Jonestown Defense
- Macaroni Defense

CONCLUSION

- There are different types takeover tactics and defense techniques.
- Use of the tactics and techniques make the takeover scenario interesting
- Both the parties try to get the best deal done and/ or act to have control over the target.
- Both parties try to use multiple mechanism.

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LECTURE: 8

TITLE: Takeover Tactics and Anti-
takeover Defenses - 3

- Buyouts
- Cases on Takeover and Defense Techniques

Keywords



- LBOs
- MBOs
- White Knights
- Buyback

Some other forms of Takeover

- Leveraged Buyout
- Management Buyout

Leveraged Buyout (LBO)

- Target firm's control is acquired by purchasing majority of their stocks using leveraged money or borrowed money
- 70-80% of the funding of the deal is through debts
- Generally after a LBO the ownership lies with few private players
- If the investors cannot pay back the debts or are in a hurry to book profits, they sell parts off the target firm to make profit and also to repay the debts
- Examples:
 - Tata – Tetley (2000)
 - Hindalco – Novelis (2007)
 - Tata – Corus (2006-07)

Leveraged Buyout (LBO) Pros. & Cons.

- Pros:
 - Less amount of capital required
 - Tax benefits
 - Excellent return on investment due to leveraging
- Cons:
 - Debt burden
 - Most of the cash flow is used for debt repayments
 - Decreasing R&D budget due to debts
 - Can cause downsizing and also exit of the business

Leveraged Buyout (LBO) Examples



- **Blackstone & Hilton Hotels:**

- Blackstone the world's largest private equity firm bought Hilton hotels a leading luxury hotel chains business
- Total deal value was \$26.2 billion which consisted of cash \$5.07 billion and a debt of the remaining amount
- After the 2008's recession Hilton's revenue fell and also Blackstone's equity value fell by 70%
- Restructuring was done in Hilton's management, operational process and debt structure
- After 6 years and 5 months Blackstone came with an exit strategy by bringing Hilton hotel's IPO and made a profit of \$8.7 billion in 2013

Leveraged Buyout (LBO) Examples contd.



- **Tata Tea acquired Tetley:**
- UK brand Tetley was acquired by Tata Tea for a record deal of 271 million pound
- It was the largest cross-border deal by an Indian company
- Tata tea became the 2nd largest tea company in the world
- This deal was the first ever LBO deal by an Indian company
- Tetley was more than 4 times bigger in net worth than Tata Tea
- A Special Purpose Vehicle (SPV)-christened Tata Tea (Great Britain) was created by Tata tea to acquire all the properties of Tetley. The SPV was capitalized at £70m
- To finance the deal, the SPV leveraged the £70mn equity 3.36 times to raise a debt of £235m
- Exposure of Tata tea was limited to the equity component of only £70 mn.
- Effectively, Tata Tea acquired a £271m company for just £70m equity exposure.

Management Buyout



- In this strategy, the management (executives) of the operating company pool resources and acquires the controlling interest of the target firm from its existing shareholders.
- In maximum cases, the management buys out all the outstanding shares and turn to private as it feels it can better manage and grow the business with the expertise of its people if it can control its ownership.
- Generally, the management team up with venture capitalist firms to organize the required fund to acquire the business.
- This type of buyout is appealing for professional managers because of future opportunities and greater rewards and controlling interest in the company.
- When majority shares is owned by the internal employees of the organization from its existing shareholders it is called an employee buyout.

Management Buyout

- Pros:

- Good investment opportunity for both management and venture capital/ hedge fund company
- Flexibility and professional management
- Confidential information of the firm remains with the key people
- The time length to take over the business can be easy and quicker
- Can execute Long term turnaround strategy or sale/ divest non core business which is not profitable for stakeholders outside of the public eye

- Cons:

- Lack of ownership experience & Lack of clarity in assuming leadership roles
- Financing the deal with too much debt
- Conflict of interest among different partners
- Transition for owners and employees can be tough



Management Buyout Examples

Dell Inc.

- IN 2013 Michael dell made a deal to take Dell Inc. private for \$24.4 Billion partnering with Silver Lake, a global technology oriented private equity firm.
- After the MBO Deal, Michael Dell has a 75% stake in the private company, the third largest computer manufacturer.
- By 2018, Dell's estimated value was \$70 Billion, three times than the value at the time of the MBO deal.

Capital First

- V Vaidyanathan is the founder and chairman of Capital First
- He quit senior level position in ICICI bank
- Captial First in its earlier Avatar was known as Future Capital Holdings, established in 2008
- Mr Vaidyanathan took a retail loan of \$120 million and also got a private equity backing of \$159 million from Warburg Pincus in 2012
- This fund was used by him to fund acquisition of Capital First
- In 2012 the market capitalization was \$120 million and it rose to \$1.2 billion after 5 years
- Later on in 2018 Capital First merged with IDFC bank to become IDFC First Bank

Modern Use of Defenses is to :

- Employ combinations, or “cocktails” of tactics (Like Staggered board with poison pill)

Cases on Takeover Tactics and Defenses

- Takeover of Arcelor by Mittal steel corp.
- Takeover of Raasi Cements by India Cements

A Battle to Remember: Mittal's fight to acquire Arcelor

- On **June 26, 2006** Arcelor agreed to be acquired by its rival company Mittal Steel Corp. at a worth of **\$33.7 Billion** in cash and stock
- The degree to the extent of which strategic moves can be played and counter played by both parties; this case can be viewed as a classic example in the takeover history of European Union.
- Main **purpose** behind this acquisition deal was **consolidation in the steel industry** thus, industry overcapacity can be reduced.
- The combined firm could also use leverage in setting the price and negotiate with both of its customers and suppliers which could benefit the company eventually a **\$1 billion annual pre-cost savings**.

Key highlights of the fight between two rival steel makers

- In 2001, Arcelor was created by combining steel companies in France, Luxemburg, and Spain. Most of its 90 steel plants are in Europe only.
- Mittal Steel Corp. is owned by Laxmi Mittal, who belongs to an important industrial family of India. The company gradually came into prominence with systematically continuous acquisition over two decades in emerging countries. Most of its companies are basically in lower labour cost countries.
- Laxmi Mittal has a 88% stake in the Mittal steel Corp. before the acquisition and the company is headquartered at Netherland basically for the purpose of saving tax.
- in January 2006, Mittal proposed his wish for acquisition of steel business of Arcelor.

Key highlights of the fight between two rival steel makers contd..

- After the initial offer rejected by Guy Dolle, the president of Arcelor, Mittal went more vigorously by announcing the **tender offer** for all outstanding shares at a premium of 27% over its current market price which will be both in stock and cash.
- With this offer, concerns from the team of Arcelor's management, Government officials and trade unions were unfavourable. Arcelor went on with one of the most aggressive takeover defence.
- In early February, Arcelor announced its plan to **buy back** of \$8.75 Billion in stock well above than the market price of company to persuade shareholders not to go for the tender offer.
- The company also **changed the law** to make payment in cash in case the success of the deal. However Luxemburg government did not approve the law.
- To persuade the shareholders, In mid-February Mittal announced that if more than half of the total outstanding shares will be submitted in the tender offer, then it would offer the remaining shareholders a **comparatively low rate** to acquire the remaining stakes through a possible merger or reorganization.

Key highlights of the fight between two rival steel makers contd..

- In late 2005 Arcelor won the deal against Metallgesellschaft to acquire Canadian steel maker Dofasco for \$5 Billion. Mittal was planning to sale his stake in Dofasco to raise money and avoid the North American antitrust concerns
- In April, 2006 after the successful completion of Dofasco deal, Arcelor appointed a three member trustee who has power to decide whether Dofasco could be sold in the next five years to stop Mittal to access the asset.
- Mittal sued legal battle against Arcelor for the above decision
- Arcelor made an exchange deal with the owner of Russian steel maker OAO Severstahl, Mr. Alexei Mordashov to gain a control stake of 90% in his company. In exchange Mordashov will own a stake of 32% in Arcelor.
- Arcelor also made tough conditions for the shareholders to deny the deal. As per the deal, more than 50% shareholders should vote against the deal to make it happen which is unlikely. This action is permissible under Luxemburg Law.
- Arcelor was well aware that only one third of its shareholders only attend the meeting to participate in the voting process.

Key highlights of the fight between two rival steel makers contd..

- Investors holding more than 30% shares of Arcelor **filed petition against the conditions** set by company to make the deal with Severstahl.
- After protest from major shareholders, Arcelor agreed to talk with Mittal and demanded a detailed proposed plan from the company. Arcelor still denied the deal although the plan was duly submitted to the company.
- In late May, Mittal **revised the bid by 34%** and announced to abolish the dual share structure in his company which gives Mittal family shares a right to exercise ten times more voting rights. So all shareholders will enjoy the same voting rights
- Even after the petition filed and renewed offer made by Mittal, still Arcelor **rejected the offer** and repeated its efforts and support for the deal with Severstahl.
- Shareholders anger continued and increased. They announced to reject the buyback offer by Arcelor as it will make the stake of Severstahl in Arcelor 38%, and as per the rule of most European countries, a stake more than one third of total outstanding shares is considered as effective control.

Key highlights of the fight between two rival steel makers contd.

- Arcelor cancelled the scheduled date of June 21 to cast vote for Severstahl and announced to both Mittal and Severstahl to submit their fresh bids by June 25.
- Finally **Arcelor agreed to make the deal** with Mittal which had been increased by 14%.
- The final offer of the deal was of \$15.70 in cash and 1.0833 Mittal shares for each share of Arcelor share. The new offer price of Arcelor's share went to \$55.54 up from Mittal's initial bid in January 2006, \$35.26
- The final offer represented a whopping **93% premium** to the initial bidding price of \$26.25 after the Mittal's initial bid.
- In the final deal, Laxmi Mittal will control 43.5% of the combined entity, Mr. Mordashov will receive a \$175 Million break up Fee, and Mittal will not lay off employees more than planned by Arcelor.

Takeover of Raasi Cements by India Cements



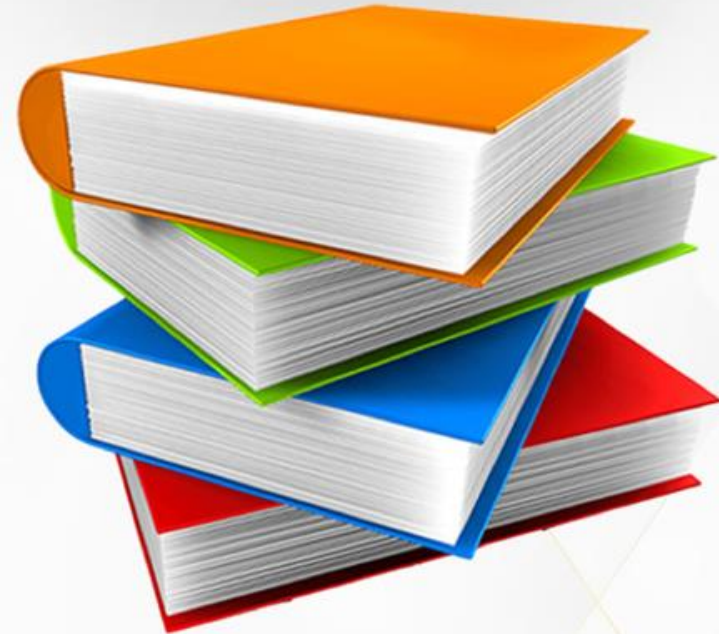
- Raasi Cements was a small entity producing cements at a lower cost, but it had some cash flow problems
- Indian Cements Ltd was relatively a very big cement company
- N Srinivasan who was the MD of Indian Cements gave an offer to Raasi shareholders to purchase their shares at Rs 300 per share which was trading at Rs 174 per share
- He offered a premium of almost 70% to the prevailing price
- Premium was so high that most shareholders would not turn down the offer
- B V Raju the founder of Raasi had 32% stake in his company and UTI had 10% stake in the company and they refused to sell their stake

Takeover of Raasi Cements by India Cements contd.



- B V Raju was unable to find a white knight to make a counter offer
- In early 1998, Indian Cements had already acquired 18% stake by purchasing from the market bit by bit from years
- At last in 1998, B V Raju sold its entire stake of 32% at a price of RS 286 per share to Indian Cements
- It made Indian Cements a controlling interest of 52% stake in Raasi
- This takeover made Indian Cements the second largest cement company in India

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LECTURE: 9

TITLE: Acquisition Search and Due Diligence - 1

- Acquisition Search
- Crucial perspectives in Acquisition Search process
- Principles of Acquisition Search
- Case study

Keywords



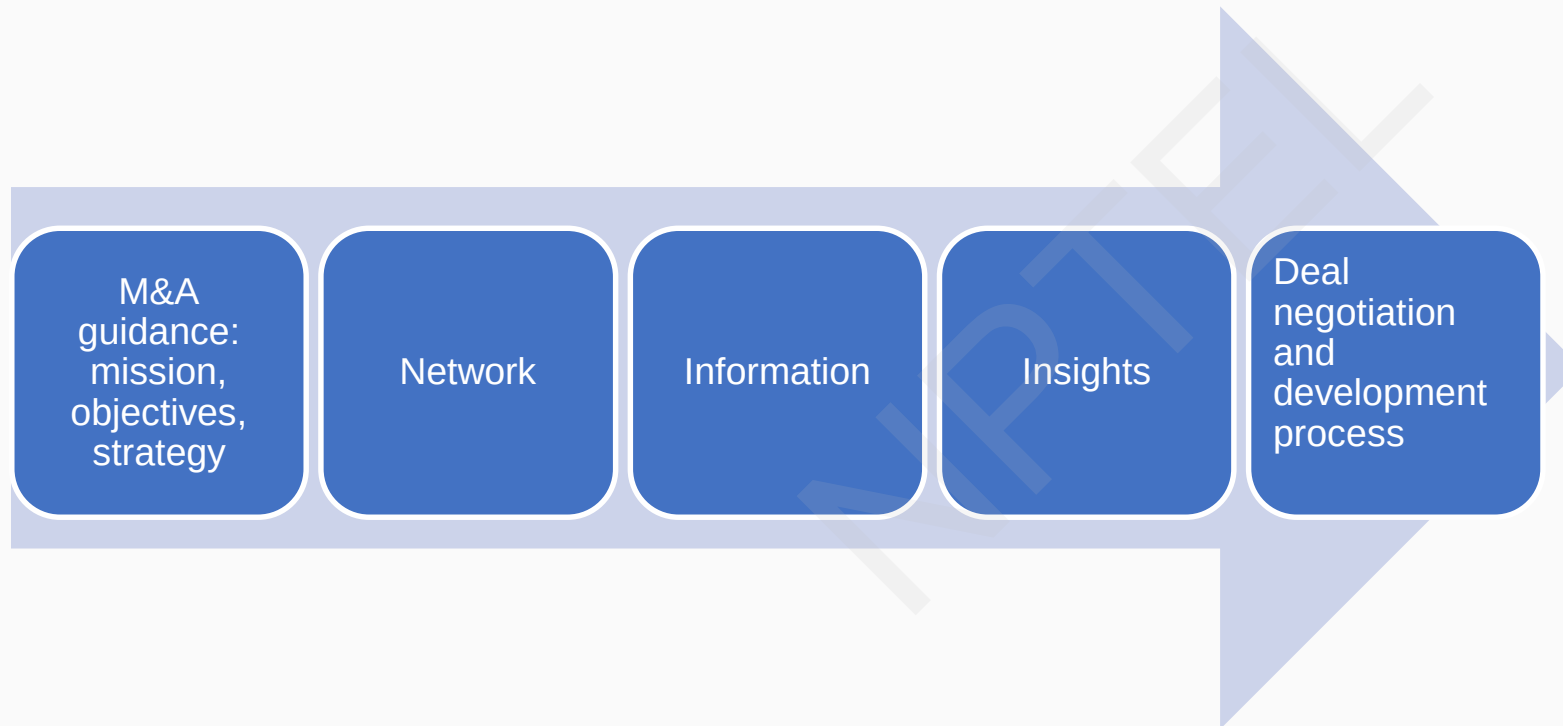
- Acquisition Search
- SWOT Analysis
- Porter's Five Forces Model
- BCG's Growth-Share Matrix
- Due Diligence

Acquisition Search

- Acquisition search is a non linear and uneven process.
- It results in small ratio of “Done Deals” against total firms reviewed.
- The acquisition search process may be done by a buyer or an intermediary.
- Tacit knowledge required from a seasoned professional.
- It also involves intelligence gathering operations.
- It is a structured search effort.

Some Principles of Acquisition Search

- Information is the currency of acquisition search



Some Principles of Acquisition Search, contd..

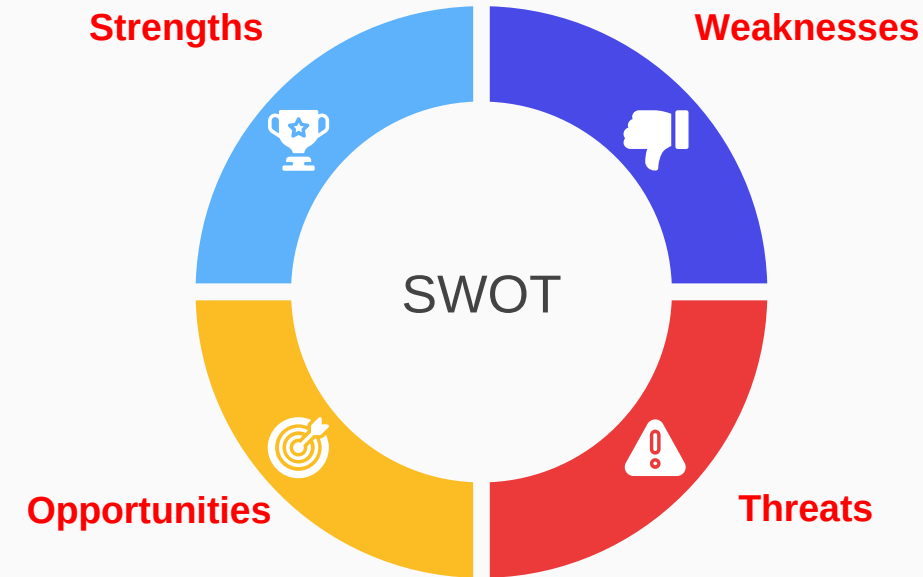
Clarity, privacy and cost: what the market knows clearly is fully priced.

	Information about the acquisition opportunity is:		
	Private	Semi-public	Fully Public
Degree of competition among potential buyers	Low	Medium	High
Likelihood that the opportunity is fully priced	Low	Medium	High
Likelihood that a buyer can intervene in ways to tailor the pricing and terms to greater advantage	High	Medium	Low

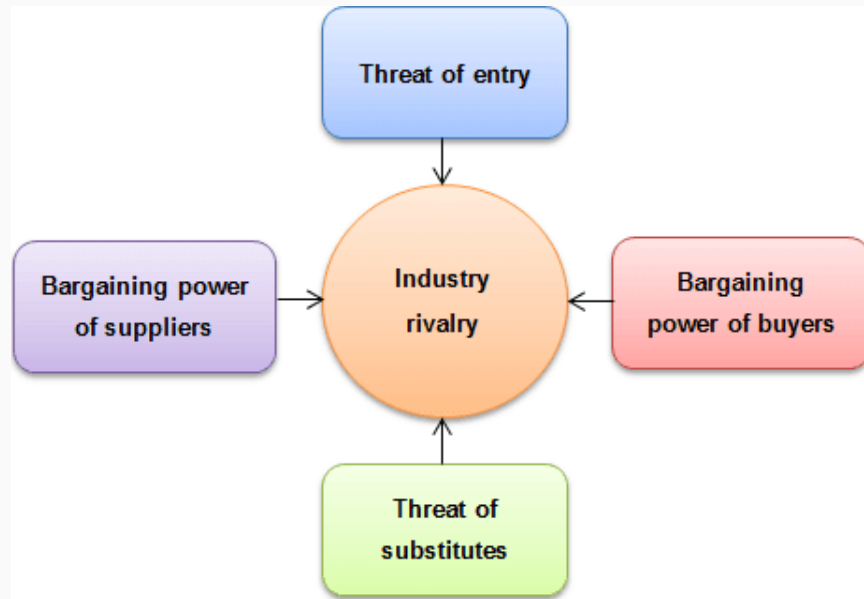
Source: Bruner, R. F. (2004)

Some Principles of Acquisition Search, contd..

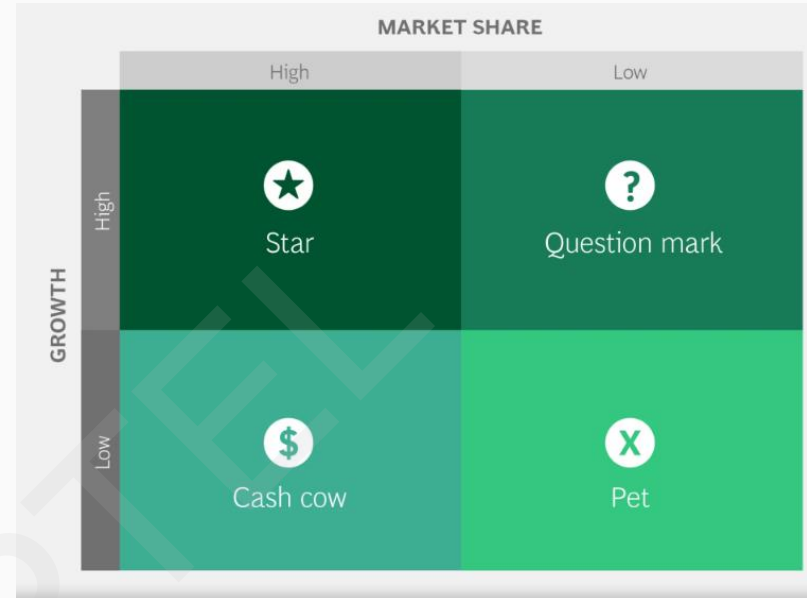
- Information arrives sequentially and must be filtered
- Screening criteria
 - Industry and position in it
 - SWOT (Strengths, Weaknesses, Opportunities, and Threats) Analysis
 - Porter's Five Forces Model (Industry Attractiveness)
 - BCG's Growth-Share Matrix



Some Principles of Acquisition Search, contd..



Porter's Five Forces Model;
Source: Porter, M. (1979)



BCG's Growth Share Matrix
Source: bcg.com

Some Principles of Acquisition Search, contd..

- Screening criteria, contd..
 - Size of the business: in terms of sales or assets
 - Profitability
 - Risk exposure
 - Asset type
 - Management quality
 - Prospective of control
 - Organizational fit

Some Principles of Acquisition Search, contd..

- Invest in social networks
- The better information is first hand
- Looking for better navigators
 - Gatekeepers
 - River guides
- Preparedness of search team to suit complexity of the environment
- Persistence and Repeated effort pay

“I am a great believer in luck, and I find that the harder I work, the more I have of it”* –

Thomas Jefferson, The third President of the United States
(*adapted from Bruner, 2004)

Acquisition Search: A real life example*

- **Aim:** to grow into one of the **top 10** auto component makers in India by **2021** and among the **top 5** by **2025**
- Under an exercise with McKinsey, the company screened more than 3,500 companies and selected 32 companies for close tracking
- Finally chosen and acquired Swedish company: Swedish powertrain component supplier TitanX (Announced in August, 2016 and completed in December, 2016)
- The deal gave the acquirer access to advance technologies and geographical reach. The company's management calls it “dream targets”.

** Compiled from The Economic Times, 06 June 2017*

Acquisition Search: A real life example, contd..

- The acquisition can only work if
 - Either there is a private equity company involved or the owners do not have the second line
 - They want to let go of the business
 - The third filter is a very critical filter, that is feasibility, which is the challenge. “That is the challenge. It has to be sustainable and profitable. You have to be a hunter, you cannot be hunted.”
- Name of the Company: Tata AutoComp systems; TitanX was previously owned by private equity firms, EQT Opportunity and Fouriertransform.

Due Diligence

Due Diligence: Introduction and definition

- Due diligence is simply research i.e. the art of doing due diligence is being lost
- Deal making is glamorous; due diligence is not
- Due Diligence defined:
 - Such a measure of prudence, activity, or assiduity, as is properly to be expected from, and ordinarily exercised by, a reasonable and prudent man under the particular circumstances; not measured by any absolute standard, but depending on the relative facts of the special case. (Black's Law Dictionary)
 - Vigilant activity; attentiveness; or care, of which there are infinite shades, from the slightest momentary thought to the most vigilant anxiety. Attentive and persistent in doing a thing; steadily applied; active; sedulous; laborious; unremitting; untiring. (court definition in a case – National steel & shipbuilding Co., V. U. S)

Due Diligence: Introduction and Definition, Contd.

- The danger is not that companies fail to do due diligence, but that they fail to do it particularly when risks (in M&A) are on the rise
- When there is demand for a thorough assessment of potential targets, and acquisitions are likely to take place when there are identifiable, quantifiable operational synergies, due diligence is obviously very important

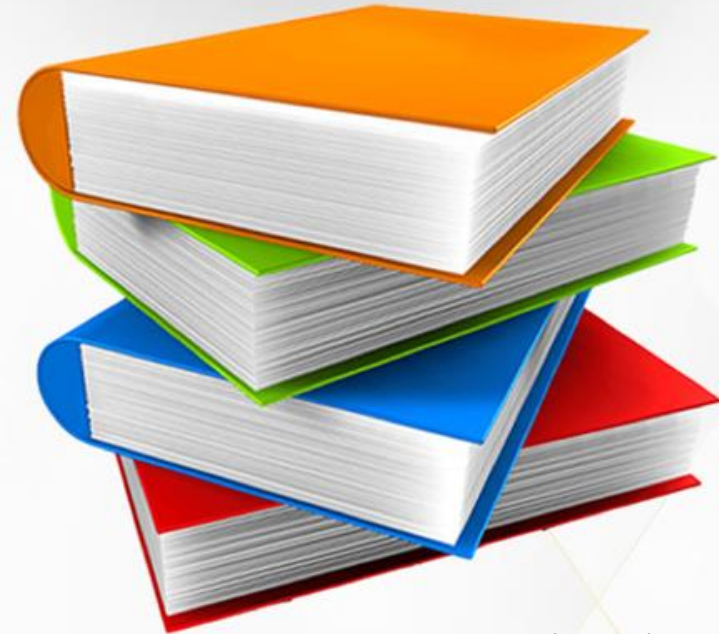
The Implications of Improper Due Diligence

- Underestimate integration and deal costs
- Overestimate savings
- Imagine synergies that do not exist
- Hence,
 - *to ensure that the acquisition is a good fit, not just on paper but as an integrated business, it calls for going beyond performing traditional financial due diligence to performing a detailed value assessment.*

CONCLUSION

- Acquisition search is an involved process linked with business strategy of the acquirer / merging companies.
- Companies adopt multiple filtering criteria while searching and selecting targets.
- Due diligence is very important aspect of M&A process.

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Thank you





N P T E L O N L I N E C E R T I F I C A T I O N C O U R S E S

MERGERS, ACQUISITIONS AND CORPORATE RESTRUCTURING

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LECTURE: 10

TITLE: Acquisition Search and Due Diligence - 2

- Due Diligence Principles
- Trade-off in Due Diligence
- Due diligence process
- Due diligence – what to look for?
- Excellence in Due Diligence
- Common Errors in Due Diligence
- Due Diligence Disasters Examples

Keywords



- **Due diligence**
- **Due diligence excellence**
- **Due diligence failures**

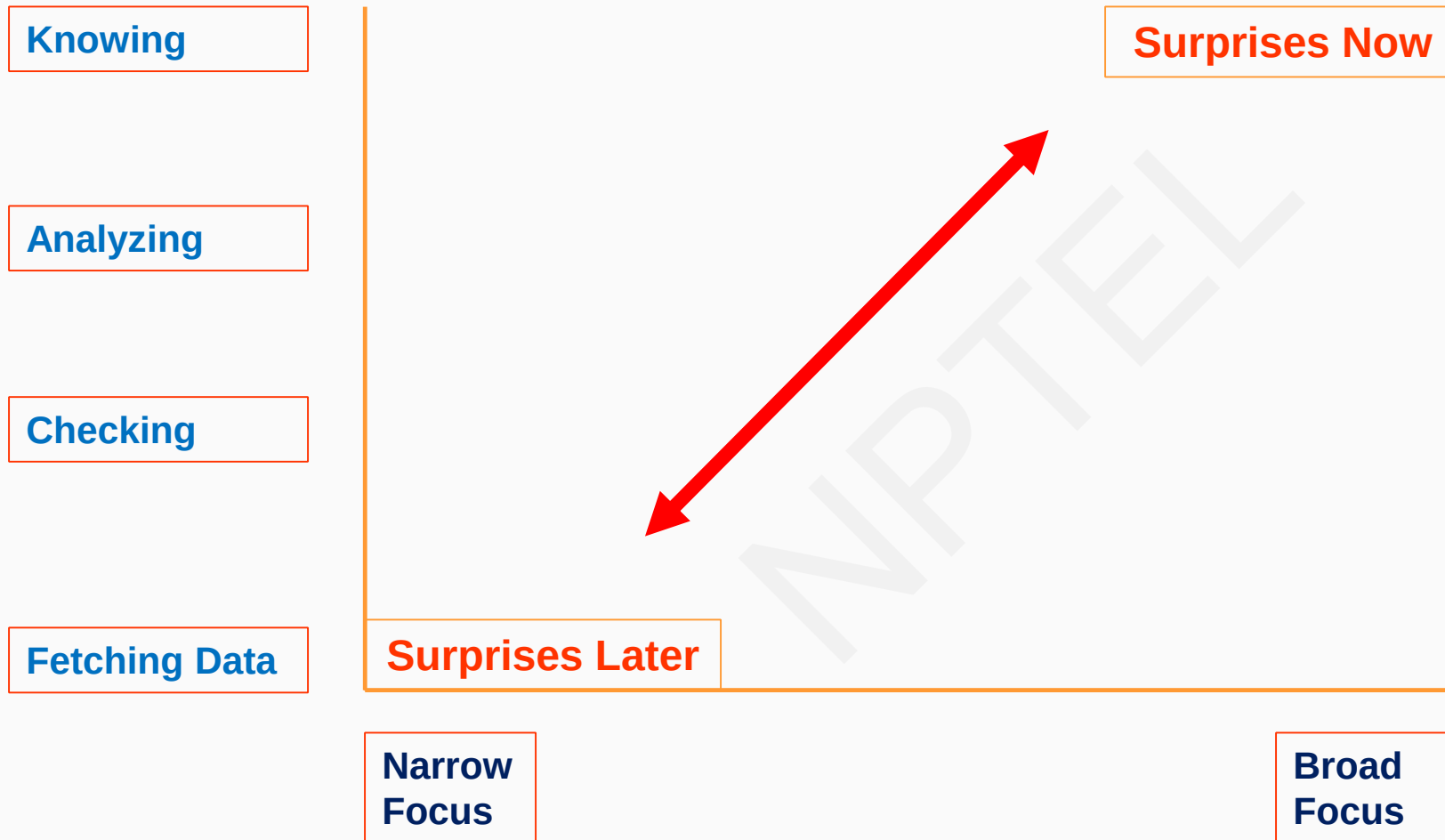
Due Diligence Principles

- To think like an investor and avoid compliance mentality
 - Not mere data-fetching and checking lists
 - Risk-return trade-off like in any other case of investment
- Due diligence is a risk management device
 - It is like investing in R&D
 - It is like buying an option that will be more valuable the greater the uncertainty about the target firm

Due Diligence Principles, contd..

- Risk bearing is always costly (it is cheapest to go without any due diligence review – like self-insuring your health!)
 - Broad review: looking at detail; more time consuming; making larger demands on the target; less about avoiding future legal proceedings and more about wise acquiring
 - Narrow review plus other insurance:
 - Brief, contained and focused;
 - Might be justified for asset acquisitions, not entity acquisitions. Can be useful when the decision to acquire is foregone conclusion
 - Trade-off between “surprises now” and “surprises later”
- Broad or Narrow, buyer always pays!

Fundamental Trade-off in Due Diligence Approach



Source: Bruner, R. F. (2004)

Due Diligence Principles, contd..

- Broad is Good: One should want to know about*:
 - Risks and opportunities
 - The past, present and future
 - The firm and its partners such as key customers and suppliers
 - The financial condition and the business that generated it
 - Internal conditions of the firm and external conditions of the firm's environment
 - The basic data of the target and the refined opinions of the experts

**Source: Bruner, R. F. (2004)*

Due Diligence Process

- Timing: The best due diligence effort begins before the buyer approaches the target. Stages:
 - First proposal
 - Signing of Letter of Intent (LOI)
 - Deadline for reaching agreement
 - Coverage of expenses related to due diligence and drafting
 - Any break-up or topping fees (Infosys's Oct-Dec, 2009 Quarterly earnings include \$7 Million break-up fee from Axon!)
 - Signing the merger or acquisition agreement
 - Closing the deal

Due Diligence Process, contd..

- Due Diligence Team
 - Attorneys (Advocates)
 - Accountants
 - Consultants and Specialists
 - Buyer Management / Employees

Due Diligence: What to Look for?

- Focus on knowledge: An insightful due diligence will have many facets and broadly 15 elements (not exclusive)*
 - Legal Issues
 - Accounting Issues
 - Tax Issues
 - Information Technology
 - Risk and Insurance Issues
 - Environmental Issues
 - Market presence and sales Issues

**Source: Bruner, R. F. (2004)*

Due Diligence: What to Look for?, Contd..

- Operations
- Real and personal property Issues
- Intellectual and Intangible assets
- Finance
- Cross-border Issues
- Organization and human resources
- Culture
- Ethics

Excellence in Due Diligence

- Research mind-set that includes the qualities like*:
 - Fact-based
 - Inquisitive
 - Knowledge-focused
 - System-focused
 - Initiative
 - Takes enough time
 - Diversity
 - Avoid surprises
 - Writes it all down: Due diligence books

**Bruner, R. F. (2004)*

Serial dealmakers like Cisco, Bank of America have :

- A dedicated merger team composed of a range of operations experts
- Replicable due diligence processes that are known, documented and can be executed - and that are in sync with the company's overall operating model
- Firm guiding principles for how the company manages key functions such as IT or supply chain operations
- Clarity (Crystal clear) about the criteria they are looking for in their acquisitions and the metrics that the deals will be judged by.

.....be prepared to walk away at any point if that's what makes business sense. successful deal makers turn down many more opportunities than they pursue. There's nothing glamorous about stepping on a landmine. [David Harding and Hugh MacArthur (2010)]

AT THE END OF THE DAY, DUE DILIGENCE IS AN UNAVOIDABLE MESSY PROCESS.

Common Errors in Due diligence

- Not taking sufficient time for due diligence
- Hard to resist a deal
 - Surrounding Initial excitement to succeed a deal
 - Good public image of the target company
 - After recruiting a large team and spending a high cost
- Verifying target's financial statement is not the only assignment; deal's strategic logic and target's ability to realise synergy are other key points
- Target could dress up to look better for the deal
- To overestimate potential synergy
- To ignore unreliable assumptions
- Gut feelings, Managerial pride

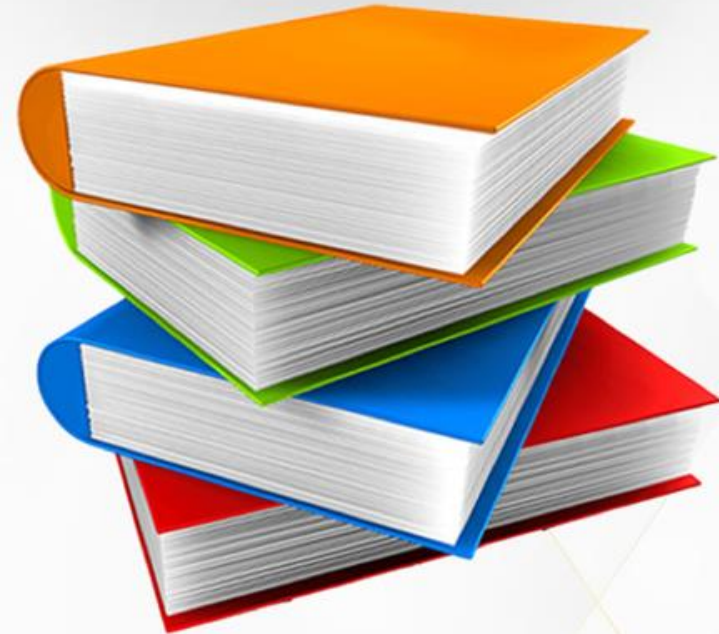
Classic Due Diligence Disaster

- **Time Warner and AOL (2004)**
 - In 2000, media giants AOL bought Time Warner at a whopping \$ 182 Billion deal, which gradually gave the merger of combined companies a stunning worth of \$350 Billion.
 - The deal happened at a time when internet was evolving and getting attention and acceptance among public as new hope, innovation, and change. The deal was made to capitalize on the wider scope between internet and mass media.
 - Lack of due diligence in company culture, failure to understand the landscape of media Industry and lack in foreseeing the future of internet costing the company to bear one of the largest failure in the history of M&A deal
- **Diamler and Chrysler (1998)**
 - In 1998 German automaker Diamler made merger deal with Chrysler at a value of \$38 Billion. The deal had expected \$8 Billion cost synergy.
 - One of the important reason behind the failure of the merger deal was cultural due diligence failure and management failure to be blinded by Chrysler's profits only ignoring poor timing of model changes, excessive inventories, rising incentives and decreasing attractiveness of the company

CONCLUSION

- Due diligence is a vital step in M&A process.
- Due diligence is just not ticking the boxes.
- Due diligence involves several aspects of the target.
- Failure in due diligence has ramifications for post merger integration.
- The buyer should be ready to walk away from the deal in case of any adverse finding during due diligence.

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Thank you

