1. Basic terminology, concepts and types of M&As

INTRODUCTION AND OBJECTIVES

In this chapter we summarize some basic terminology and concepts on M&As for developing further knowledge and understanding. We distinguish between different types of M&As, horizontal, vertical and diversified, from an economic point of view, focusing on the economic effects produced and the environmental conditions that favour a coherent and effective growth strategy. Then, we point out the differences between friendly and hostile acquisitions and the main defences used to stop the hostile takeovers. As the growth of a firm can also be carried out through internal development, a comparison between the advantages and disadvantages of M&A with internal development is presented at the end of the chapter.

MERGERS AND ACQUISITIONS: BASIC TERMINOLOGY AND CONCEPTS

M&A can be defined as a process in which two or more firms are combined to share their assets and resources and thus achieve common objectives, and in which the management of the two firms negotiate the terms of the deal which are then put in front of the shareholders for their approval.

M&A operations are ways of carrying out growth strategies through external operations. The terms “merger” and “acquisition” are often used as synonyms, even if they are different from a legal point of view. In particular, an acquisition is the buying of the totality or the majority or of a relevant percentage of a company’s shares, sufficient for ruling the company if the propriety is spread among many shareholders. A merger, on the contrary, is an integration among companies with the annulment of the acquired firm, when this is incorporated by the acquirer (merger by incorporation), or the annulment of all firms when a new company is set up from the concentration of the companies in the merger transaction (merger by union).

More precisely, in the merger by union, a new legal entity is created from the participant companies, which lose their legal separate identities because of the merger. The entire capital of the merged companies is transferred to
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the new company, whose shareholders are all the shareholders of the merged companies.

On the contrary, in the merger by incorporation, one of the companies interested, the acquirer, incorporates the other company. Also in this case, the capital of the merger company is equal to the sum of the capital of the companies involved in the deal, but the legal identity of one of the companies in the merger transaction is preserved. Precisely, the acquiring company remains with its separate legal identity, while the other company goes out of existence.

The merger by incorporation is the most commonly used form because of its simplicity from a legal standpoint. In a merger by incorporation, three different cases are possible.

- The acquiring company does not own shares of the incorporated company. In this situation the acquiring company will pay cash for the shares of the incorporated company or it will exchange the new shares issued itself with the shares of the acquired company, according a well-defined exchange ratio. Then, the shares of the acquired firm will be annulled.
- The acquiring company already owns all the shares of the acquired company. In this situation, the merger will be carried out simply by the annulment of all the shares and the participation of the acquired firm.
- The acquiring company already owns a percentage of shares of the target firm. In this case, the holding company will increase its capital with the issue of new shares that will be exchanged with the shares of the acquired firm that it does not own yet. Then, all the shares of the target firm will be annulled by the merger firm.

Frequently, the term merger is simply used from an organizational standpoint, that is viewing the merger as a partial or a complete integration of the managerial functions in a single business structure, without a change in the legal profile of the companies involved, which remain separate legal entities.

Having made this clarification, we observe that in an M&A operation the participants have different objectives. The vendor aims to increase the selling price to the maximum level, while the acquirer wants to reduce it to the minimum level. To successfully close the deal, high competences are required, of financial, legal, organizational and strategic type. For this reason, in M&A operations some advisors are present for helping the vendor and the
acquirer to correctly evaluate the companies, to verify if the operation is possible and to solve all technical issues.

Finally, we want to point out the difference between the M&A operations and the simple acquisitions of assets or business units of a company. In this case, the payment of the acquired assets is made directly to the vendor company, not to its shareholders. This form of acquisition, which is not examined in this study, can be advantageous in some situations, because it allows the selection of the activities to be bought, thereby avoiding the debts to be borne by the acquired firm. In some cases, the same purpose can be reached by transferring the required assets and activities to a new company, whose shares will then be acquired.

THE PROCESS OF ACQUISITION AND MERGER

In M&A operations the following key phases can be identified.

a) The evaluation of the target company. Once a company has been identified as a potential objective of the merger, it is necessary to evaluate if it has the required characteristics to create value for the acquirer.

b) The dealing and the agreement between the parties. The second phase is represented by the dealing between the parties to reach the planned objective in terms of price and method of payment.

c) Finally, the third phase is represented by the integration or consolidation of the companies interested in the merger. In particular, it is a matter of defining the organizational structure and the management procedures which are more suitable for reaching the planned target in terms of integration and performance.

TYPES OF M&As

M&As can be characterized by different growth patterns, according to the opportunities offered by the environment and the disposable resources the firm has.

Growth can be carried out through horizontal expansion processes in the business in which the firm is already operating. Moreover, growth can be accomplished through entrance into a different business, related or unrelated to the business in which a firm is already operating.

We will distinguish three different M&A strategies:
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- horizontal M&A;
- vertical M&A;
- product diversified M&A.

We refer to horizontal M&A when a firm carries out an M&A to expand its production and sales capacity in the existing market or in different local or international markets, continuing to operate in the same industry or business with the same basic product. The extension to different market segments through new types and models of the same basic product, is also considered as a horizontal expansion.

We refer to vertical M&A when a firm decides to acquire firms making operations or phases of activity located upstream or downstream with respect to the present activity or firms making components or services which before were acquired from other firms.

Finally, we refer to diversified M&A, when a firm acquires firms operating in different industries or businesses with substantially different products, related or unrelated to the existing ones. In this case we will distinguish between:

- related diversified M&As, when businesses are related either by markets or by product technologies;
- conglomerate diversified M&As, when businesses are not related either by markets or by product technologies.

In our view, the introduction of different models or types of a given basic product, directed at different market segments (for example a new type or model of sunglasses), does not constitute a diversified strategy, but a horizontal expansion strategy.

The proposed classification goes into less detail than those proposed by other authors (Ansoff, 1968; Rumelt, 1974; Rispoli, 1998), because it aims principally at emphasizing the fundamental difference between the structural firm changes required by M&A strategies involving entrance into different industries and those involving further expansion and penetration into the industry in which a firm is already operating.

In economic terms, a horizontal M&A determines an increase in the quantities produced and sold of a given product; a vertical integration strategy determines an increase in the added value of a firm; and a diversified strategy determines the production and sale of a different product (Table 1.1).

As will be clarified in the following chapters, each M&A strategy implies different changes in the combined firm structure and requires different resources for it to be successful. Also the environmental conditions favouring
Basic terminology, concepts and types of M&As

one or the other strategy are very different. Therefore, the analysis of the firm structure and the environmental conditions form the bases for a coherent formulation of an M&A strategy (Dringoli, 2011).

Table 1.1 M&A strategies and main economic effects

<table>
<thead>
<tr>
<th>M&amp;A strategies</th>
<th>Main economic effects</th>
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<tbody>
<tr>
<td>Horizontal expansion</td>
<td>Increase in quantities produced and sold and consequent increase in revenues and costs.</td>
</tr>
<tr>
<td>Vertical integration</td>
<td>Increase in added value.</td>
</tr>
<tr>
<td>Product diversification</td>
<td>Production and sale of a different product and consequent increase in revenues and costs.</td>
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FRIENDLY AND HOSTILE ACQUISITIONS

Acquisitions can be friendly or hostile. In the latter case, the target firm does not accept the takeover bid and adopts defensive actions to avoid it (Brealey and Myers, 1996; Weston et al., 2004; Sudarsanam, 2010). For example, it repurchases its shares or it looks for an available partner (a white knight) for accomplishing a friendly acquisition, or it tries to defend itself through poison pills, such as taking on a big new debt, or selling assets, or calling for Antitrust Authority intervention, etc. In Table 1.2 some defensive actions against a hostile acquisition are shown. Frequently, managers do not wait for a hostile bid before taking defensive action, but deter potential bidders by using poison pills that make their companies more expensive or more difficult to run.

Shareholders of the target firm can contest the takeover bid in order to extract a higher price from the acquirer; on the contrary, managers can contest the takeover because they believe their jobs may be at risk in the merged company. So they will try to stop the bid to save themselves, not to obtain a higher price for shareholders.
### Table 1.2  A summary of the main defences from hostile takeovers

<table>
<thead>
<tr>
<th>Types of defence</th>
<th>Description</th>
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<tbody>
<tr>
<td>Extension of the board term</td>
<td>The term of the current board of directors is extended so that the bidder cannot gain control of the target immediately</td>
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<tr>
<td>Supermajority</td>
<td>A higher percentage of shares is needed to approve a merger, for example 80%</td>
</tr>
<tr>
<td>Fair price</td>
<td>Mergers are restricted unless a fair price is paid</td>
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<tr>
<td>Restricted voting rights</td>
<td>Shareholders who own more than a specified proportion of the shares of the target firm have no voting rights for the exceeding shares</td>
</tr>
<tr>
<td>Poison pills</td>
<td>Disinvest specific assets making the company unappetizing for the bidder</td>
</tr>
<tr>
<td></td>
<td>Buy assets that the bidder does not want, and increase the company debt</td>
</tr>
<tr>
<td></td>
<td>Buy assets that will create an antitrust problem for the bidder</td>
</tr>
<tr>
<td></td>
<td>Issue shares to a friendly third party or increase the number of shareholders and the capital to be purchased</td>
</tr>
<tr>
<td></td>
<td>Distribute reserve funds to shareholders as dividends, thereby reducing the company capital and increasing the leverage</td>
</tr>
<tr>
<td>White knight</td>
<td>Seeking a partner who is available for a friendly acquisition</td>
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</tbody>
</table>

### COMPARING M&A WITH INTERNAL DEVELOPMENT

The choice of growing through acquisition instead of internal development requires comparing the advantages and disadvantages of the two alternatives (Table 1.3).
The advantages of internal development are the following:

- the investment can be defined precisely in relation to the actual needs and objectives of the firm;
- the investment can be made gradually in relation to the disposable resources.

The disadvantages of this alternative are the following:

- the investment determines an increase of production capacity in the industry with the risk of overcapacity if aggregate demand does not grow adequately; overcapacity in an industry can cause a price war among the competing firms with a consequent fall in margins and cash flows;
- the expansion of production can take a long time, as it requires building plants and obtaining the right machinery.

Table 1.3 Comparing M&A with internal development

<table>
<thead>
<tr>
<th>Benefits</th>
<th>Internal development</th>
<th>M&amp;A</th>
</tr>
</thead>
<tbody>
<tr>
<td>Benefits</td>
<td>Right dimension of the investments</td>
<td>Objective rapidly reached</td>
</tr>
<tr>
<td></td>
<td>Efficiency in investment location</td>
<td>Easily overcoming the barriers to entry</td>
</tr>
<tr>
<td></td>
<td>Use of new technologies</td>
<td>Rapid increase in the market share</td>
</tr>
<tr>
<td></td>
<td>Quick integration of the investments into the existing firm structure</td>
<td>Opening of strategic windows</td>
</tr>
<tr>
<td></td>
<td>Simple and easy decisional processes</td>
<td>Positive effects on the firm image</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Exploiting fiscal advantages</td>
</tr>
<tr>
<td>Drawbacks</td>
<td>Increase in production capacity and negative effects on product prices</td>
<td>Difficulties in integrating firms</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Acquisition costs and uncertainty of firm value</td>
</tr>
</tbody>
</table>

Alternatively, growth through acquisition presents the following advantages:
Merger and acquisition strategies

- a greater rapidity in implementing the production expansion;
- a more rapid increase in customers’ portfolio, sales and market share;
- an easier entry into a market or business;
- no increase in the aggregate supply of industry;
- the exploitation of synergies and new competences and know-how.

Conversely, growth through acquisitions has the following disadvantages:

- difficulty in correctly evaluating the target firm because of limited information;
- difficulty in estimating the integration time and costs of target firms.

Often, a firm decides to grow through acquisition when it can rapidly carry out a relevant increase in size, reducing the number of competitors and increasing its market share and thus its bargaining power.

However, management must not underestimate the costs of integrating different organizational structures. Empirical evidence shows that mergers and acquisitions frequently bring positive short-term return for shareholders of target firms, but more questionable long-term benefits to investors in acquiring firms.

Even though empirical studies highlight the wide variation in the results of acquisitions at the firm level, they show that, at the aggregate level, only 40–50% of acquirers do achieve positive returns in the two to three year period following acquisition (Kitching, 1974; Gregory, 1997; Agrawal and Jaffe, 2000; Capron and Pistre, 2002). This subject will be analysed in depth in Chapter 2.

NOTE

1. This classification of mergers and acquisitions is largely used in the literature. On this point see, for example: Porter (1985); Hitt et al. (1997); Weston et al. (2004); Gugler et al. (2003). A different classification is proposed by Bower (2001) who identifies five distinctive varieties of M&As on the basis of differing challenges the management want to face: overcapacity M&A, the geographic roll-up M&A, the product or market extension M&A, the M&A as R&D and the industry convergence M&A.