Surviving the crisis through M&A

OVERVIEW

FOLLOWING the global financial crisis, the business world is seeing many changes. Even as corporate restructuring acquires new vigour, mergers and acquisitions (M&As) have gained added importance.

In an ongoing Nanyang Business School-Business Times Roundtable discussion series, senior professors at Nanyang Technological University's business school delve into the whole issue of M&A and try to find out if it is, in fact, one of the ways to survive a financial crisis.

Narendra Aggarwal: As we start the discussion on M&A, could I ask you to begin by telling the readers why and how M&As take place and include highlights of some of the key benefits?

Dr Jun-Koo Kang: Before we talk about this issue, it's useful to know about what we mean by M&As. Mergers mean the combination of two firms. The acquiring firm acquires all assets and liabilities of the acquired firm. Mergers usually take place following friendly talks between two companies.

Acquisitions can be of several types. One is acquisition of another company's assets without taking over any liabilities and there is no change in ownership. Another form of acquisition is to acquire a controlling equity interest in a company, which is typically accomplished via a tender offer – an offer to buy shares from existing shareholders for cash and/or securities. Finally, there can be a leveraged buyout by investors, who acquire other companies by borrowing from banks.

Dr Angie Low: Corporate restructuring through M&A aims to reallocate assets more efficiently across an economy when companies react to shocks and changes in the market place.

Sometimes they find that their current capabilities may not be enough to meet their needs to adapt to the environment. So they go to the market to acquire resources, which can be human resources, talent, knowledge, customer base, economies of scale and scope – all the competitive advantages that a company may want to strengthen itself.

Dr Kang: While a company can grow internally, the other and sometimes faster way to grow is through acquisitions. M&A can create synergy for a company. Synergy can occur through increasing productive gains, vertical integration, and increased utilisation of production technology.

Also, there could be tax savings by combining two companies if one of them has some unutilised tax loss. Tax benefits are also available through increased depreciation deductions obtained by stepping up the basis of assets and increased leverage. Synergy is one of the key reasons why M&As take place, and may not be possible to achieve internally.

Dr Nilanjan Sen: The significance of M&A activity can be seen from the US$3.7 trillion global volume in 2006. This represents the market for corporate control, in which different managerial teams around the world compete with one another to seize more corporate resources.

This is a process of global resource allocation, hopefully in the right direction, as well as corporate restructuring to reposition organisations for the future. You may have got into areas that may no longer be consistent with your strategic mission. M&A allows you to retrench some of these resources and seek better alignment with long-term goals.

Dr Ho Kim Wai: While the benefits and motivation for M&A include reducing industry overcapacity, M&A also enables companies to divest assets that are no longer core to the business due to changing corporate strategy and future growth direction.

M&A can be one strategy for growth. However, before going in for M&A, a company has to look at what its key strengths are and decide whether it wants to go for M&A to complement its organic growth.

Turning to Singapore companies, for many of them, M&A overseas is the only way to overcome growth constraints in Singapore due to the limited size of the local market.

At the same time, M&A enables companies to increase their global footprint for distribution channels and production capacity, and even acquire resources and raw materials from other countries.

Mr Aggarwal: In the years preceding the onset of the global financial crisis last year, there was a huge jump in M&A activity, especially by private equity firms. What led to this sharp increase in M&A activity?

Dr Sen: Almost 40 per cent of M&A deals in 2006 and 2007 took place in the private equity space. Private investor groups have been buying out companies, including publicly listed firms, using substantial amounts of debt. The low interest rate environment, better managerial compensation and rising asset valuations provided the incentives for such leveraged buyouts.

A private equity firm shields acquired companies from market pressure to produce quarterly profits and makes significant strategic changes in an organisation, enhancing its value in the process before taking it back to the market at much higher prices after three or four years.

Dr Kang: We have to be careful in the assessment, as in many cases M&As can lead to failure. For instance, 40 per cent of leveraged buyouts eventually fail. There could be many reasons for failure.

In an M&A there should be enhancement in the value of the bidding company as well as the target company. For example, the target company's value can go up if there is synergy after the merger, which is not always the case.

Evidence suggests that when a bidding company makes an announcement about its bid, the stock price of the target company goes up, while that of the bidding company sometimes goes down and may stay low for as long as five years, as seen in some cases. One of the reasons could be management entrenchment.

Dr Ho: The goal of private equity is clearly to make money – and in the shortest possible timeframe. The business model of private equity is to take on cheap debt and leverage it up, aiming for high rates of return from targets that can generate lots of cash. Banks are generally willing to lend to private equity firms, and because these firms make money, more people are willing to put their money into them.

Private equity firms align their asset portfolios with their own strategy. So they divest what they do not need and add new assets to acquired companies to grow them.

Dr Low: The easy credit environment in part helped fuel the rise of M&As by private equity firms. Also, private equity firms managed to raise huge amounts of money from investors.

Panellists from NTU's Nanyang Business School:
- Jun-Koo Kang, distinguished professor of finance;
- Nilanjan Sen, associate dean, Nanyang Executive Education; director, Nanyang Fellows Programme and associate professor of finance, NBS;
- Ho Kim Wai, associate professor of banking and finance;
- Angie Low, assistant professor of banking and finance.

Moderator: Narendra Aggarwal, director, public affairs

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'In the aftermath of the financial crisis, only cash-rich and good-performing companies can be key players in the M&A market.' *– Dr Kang*

'The M&A market makes it possible for companies to readjust their portfolios to their revised strategy as their business evolves.' *– Dr Ho*

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These institutional investors, which include entities such as university endowment funds and public pension funds, are seeking a higher return than they can earn by investing in the public equity markets.

On the other hand, because of increased regulatory oversight of public firms – especially after the enactment of the Sarbanes-Oxley Act in 2002 – it was increasingly difficult to be a public company in the US. Therefore, there was a ready supply of funds for acquisition purposes – and a ready supply of targets who wanted to go private.

Mr Aggarwal: Why is M&A such an important aspect of corporate strategy and what are some of the other motivations for such activity to take place?

Dr Ho: From a strategic point of view, now is a good time to re-look at company strategies and portfolios. Companies not doing too well should take stock of whether they expanded too fast in the past and may have gone into some businesses in which they do not have sufficient expertise to add value. So you have to consider what you want to keep and what you want to dispose of, which is difficult for many managers as such restructuring could result in large write-offs.

I would suggest that companies re-channel their resources to new areas – and areas in which they have strengths. For companies that are really struggling, it may be time to shed some of their activities and assets, perhaps even shed some of the crown jewels, because if they do not do so, they could be out of business soon.

In fact, the M&A market makes it possible for companies to readjust their portfolios to their revised strategy as their business evolves.

A case in point is Keppel Corporation's decision to divest its stake in Singapore Petroleum Company (SPC) to PetroChina International. For PetroChina, acquiring SPC allows it to add desired assets to implement its internationalisation strategy and "provide a broader foundation and stable path for development". And for Keppel, the SPC divestment generates cash to grow its business in the desired direction.

Dr Sen: One of the considerations for M&A, especially in the current difficult economic climate, is to cut down on duplication in marketing and distribution networks and run parallel or similar R&D outfits. This could be the motivation, for instance, for recent mergers among global pharmaceutical giants.

If, let us say, they were spending $200 million each on R&D every year and going for the same results, the merged entity could save $100 million by cutting each company's spending to $150 million, and perhaps have an even stronger R&D organisation in the process by getting the scalability factor.

Similarly, when two banks merge, they can achieve synergy by cutting down on branches in the same location, and in fact have a much stronger distribution network on the basis of their combined strength.

Dr Kang: In both these cases, very industry specific activity is needed to achieve synergy. It usually takes place when there is excess capacity in a specific industry. The key players usually decide to get together when they want to get rid of the excess capacity.

Dr Low: M&A can take place not only for expansion but also for consolidation. While in the 1990s most of the M&As were for expansion of industries as assets were added, in the 1980s they were more for consolidation, as excess assets were being cut away. This all depends on business cycles. M&As can aid in the expansion of an industry or contraction of an industry – they are a very good tool for reallocating assets across companies.

I think that not all M&As are necessarily good. There are a lot of cross-sectional variations. Perhaps it can be said that when an M&A is done for diversification, it usually does not add more value, whereas when an M&A is more focused, it is more advantageous in some markets.

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When it is driven by synergy, the chances of success are very high. However, a lot of the success – or otherwise – of an M&A depends on the post-integration process.

Further, taking over a company could be driven by the managers' own motivation for the company to become bigger so they can get better remuneration packages. Studies have shown that when companies get bigger through M&A, the CEO benefits through increased pay, especially new option grants. And this is regardless of whether a deal is good or bad.

Mr Aggarwal: Moving on, does M&A serve as a corporate governance mechanism that reduces managerial incentive problems?

Dr Kang: M&A can be considered as the market for corporate control, which means it can serve as an important corporate governance mechanism by acting as an external force to prevent top managers undertaking unprofitable investments and wasting stockholders' wealth, or to prevent top managers from over-rewarding themselves by being a threat to them to do their job well.

An impending M&A can, in fact, serve as a threat to the top management of a target company to perform well because if it takes place, many of the target managers stand to lose their job, as M&As usually result in a significant chance of top managers in a target company losing their job. This threat provides top management with strong incentive to run a company effectively.

Dr Sen: M&As are very important in the United States as a governance tool, but in Asia the ownership structure is very much dominated by family or government holding. Even in the US context, any time the shareholding is around 30 per cent or more for a particular management team or a family, there is no way an M&A is going to take place – at least in a hostile fashion.

Dr Ho: Quite often, companies under-performing their peers in the market are likely to be takeover targets, and their top managers probably understand they would lose their jobs if their companies were to be taken over. In this regard, the threat of a takeover could drive the managers to be more efficient.

Mr Aggarwal: Analysts estimate that private equity funds have a war chest of US$20 billion to spend on buyouts in Asia. With broader market sentiment improving, do you foresee an increase in M&A activity in the region?

Dr Sen: I see a substantial increase in M&A activity taking place here in Asia. The markets are saturated in the West, and when you put the current crisis on top of that, there is increasing consensus that the US economy is not going to go back to its previous growth level for another three to four years.

Western companies are now focusing on Asia and banking on it as the region returns to the growth path. Both Western and Asian companies are seeking to acquire small and medium enterprises that may be struggling due to extremely tight credit markets. The primary motivation seems to be gaining market share in the region that may provide the maximum growth prospects in the future.

At the same time, emerging Asian MNCs are now ready to step out of their home markets. They are keen to acquire firms in the region, as well as in America and Europe. The expected weakness in the US dollar and attractive valuations may provide the additional financial incentives. The successful Asian companies can fund these small to medium acquisitions from internal resources or by raising $50-$100 million, as they are not necessarily looking to acquire large companies.

Dr Ho: We can see a recent trend that companies, especially those with strong shareholders, are raising capital through rights issues, not only to strengthen their balance sheets, but also to build a war chest for potential acquisitions. Recent cases include CapitaLand and NOL. We see similar trends in other capital markets.

Dr Kang: Asian companies are already starting to make inroads into the West. Whether it is Lenovo or Tata, we will see more such cross-border acquisitions of Western companies taking place.

In fact, the weakening of the US dollar provides an opportunity and makes it much more attractive for Asian companies to acquire companies in the West at a much cheaper price.

Dr Low: Cross-border mergers are sometimes very tricky due to protectionism and constraints like that. We have had the recent case in which Coke failed to acquire a big soft drink company in China. So, companies have to be very careful when considering M&As across borders.

Perhaps that is why some international M&A activity is concentrated on small and medium enterprises, where possession of domestic assets by a foreign entity is not seen as a threat by countries that focus on trying to protect their crown jewels.

Dr Ho: Companies going for cross-border acquisitions should be mindful of the challenges in doing due diligence. The inability to do proper due diligence in foreign countries is one of the key risks in cross-border M&As.

Dr Sen: I must point out that for cross-border M&As, the greatest challenge is post-merger integration. On paper there may be substantial opportunities for synergy gains. But trying to combine two companies that may be in the same industry but have very different cultures is not easy in real life.

Dr Kang: We know that cross-border mergers are often driven mainly by synergy, and thus while the cultural differences arising from the different countries the companies operate in are real, cross-border mergers can sometimes be very successful due to the synergy achieved.

Dr Low: When we have a crisis like now, it is boom time as well for M&A. That is when you have consolidation and it weeds out the bad companies and leaves only the strong companies. That is why M&A is one tool, other than bankruptcy, to achieve reallocation of assets.

Dr Kang: At this point we have to remember that in the aftermath of the financial crisis, only cash-rich and good-performing companies can be key players in the M&A market, as those with financial constraints cannot go for M&As – no matter how attractive they may look – because of their lack of resources.