SELECTING AND ASSESSING A TARGET FIRM FOR AN INTERNATIONAL MERGER OR ACQUISITION

ELENA NIKOLOVA, *Ass. MSc.*[1], MARIJA GOGOVA, *Ass. MSc.*[2], MARGARITA MATLIEVSKA *Ass. Prof. PhD.*[3], KRSTE SAJNOSKI *Ass. Prof. PhD.*[4]

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Abstract

International mergers and acquisitions (M & A) as a way of restructuring the companies represent an important part of the world of corporate finance. Every day the Wall Street investment bankers arrange M & A transactions in which individual companies are merging together to form larger and stronger companies than they are. Not surprisingly, such activities often appear on the news. These contracts totaled hundreds of millions, even billions of dollars. They determine the future of the companies involved and all their employees, which is far from irrelevant. The executive director who manages the acquisition or the merger could achieve the peak in his/hers career with this transaction. And no wonder we hear so much about these transactions because they happen all the time. The next time you open the newspaper in the area of Business and Economics the chance to read at least one title for some kind of M & A transaction is really great.

The basic idea: one plus one makes three - is an equation with a special alchemy for mergers or takeovers. The key principle of merging or buying a company is to create higher value than the sum of individual values of both companies. The two companies together are more valuable than two separate companies, at least, that's the reasoning behind M & A. This explanation is particularly attractive to companies when times are tough. Strong companies will seek to buy other companies to strengthen their position and be competitive. The companies share a common hope that they will gain more market share or achieve greater efficiency. Because of these potential benefits, target companies often agree to be purchased, especially when they know they can’t survive alone. Regardless of their category or structure, all mergers and acquisitions have one common goal: they are meant to create synergy. The success of mergers or acquisitions depends on whether this synergy is achieved and which is the price for that goal.

Identifying the target company. There are several ways to identify which company is most suitable target company for a merger or acquisition. One of the most exploited principle is *creating a profile of the target company*. The profile includes the desired features that the company should possess, as to be compatible for a merger or a takeover. The list of features includes: type of activity, size of company, its market position, number and structure of employees, production range, the structure of assets and equity, profitability, indebtedness and liquidity, and many similar indicators. Once you create a profile of the target company, it is time to find such a company and access it with an appropriate offer. Best practices usually create a list of potential target companies, which includes:

- Current competitors’ companies
- Suppliers’ companies
- Distributors’ companies

[1] *Department of Management, Faculty of Economics, University of “Goce Delcev”, Stip, Macedonia*
E-mail: elena.nikolova@ugd.edu.mk
[2] *Department of Finance, Faculty of Economics, University of “Goce Delcev”, Stip, Macedonia*
E-mail: marija.gogova@ugd.edu.mk
[3] *Department of Management, Faculty of Economics, University of “Goce Delcev”, Stip, Macedonia*
E-mail: margarita.matlievska@ugd.edu.mk
[4] *Department of Finance, Faculty of Economics, University of “Goce Delcev”, Stip, Macedonia*
E-mail: krste.sajnoski@ugd.edu.mk

To increase efficiency in identifying potential target, the company animates their best employees to gather relevant information and to make proposals and arguments for their choice. The company can also hire appropriate experts or consult an investment bank. The latter, inevitably, have much more information about market conditions in individual industries and the economy as a whole. Their suggestions are a source of relevant information for making the right decision when choosing a target company and increase the likelihood of success of the potential merger or acquisition. Mergers or potential acquisition can be successful when targeted company:

- Is undervalued or has a higher fair market value;
- Does not use optimally its resources and capacities;
- Has complementary products / services with the potential buyer;
- Has poor management.

Once you have found an appropriate company for a merger or acquisition you should choose the best way to approach the managers or owners of that business. One of the most important information that should be available to the potential buyer is whether the target company, i.e. its general managers, wants to make any kind of restructuring. In many cases, the potential buyer hires certain experts or special institutions to "feel the pulse" of the target company for potential acquisition or merger and to collect numerous information about it. In this way, the company manages to acquire not only the relevant information, but to get professional advice from third parties, the attorneys, lawyers, economic experts, consultants and investment banks, etc.. Experts can help a lot in providing information on:[5]

- Market conditions and future changes
- Factors that influence the market prices
- Future prospects of the company
- Competitors in the industry

Evaluating the target company. For a successful merger or acquisition it is necessary to conduct a proper assessment of the target company. Logically, the list of information sources includes those that have direct contacts with the target company, its suppliers, distributors and consumers. For example, questions that would answer customers are:

- Perceptions and opinions about company’s products / services
- Comparison with those of competitors
- Suggestions for improvement and so on.

Such data, qualitative or quantitative, is subject to further processing in order to establish some general trends, the general opinion about the company's value and image. The list of questions that seeks answers from the targeted company includes:[6]

- Financial information, if unaudited, it is desirable for the buyer to provide its own independent audit;
- Trends in sales and profit margins;
- Future forecasts for sales and market in general;
- Capital structure;
- Fluctuations in the value of shares and payments of dividends;
- Level of indebtedness of the company;
- Information on marketing mix;
- Information for employees: number, structure, knowledge, skills, abilities, training plans and training and so on;
- Information for suppliers, creditors, customers;
- Legal aspects and contracts and so on.

[5] Miller, L. Edwin, *Mergers and Acquisitions: Legal and Practical Guide*, John Wiley & Sons Inc., New Jersey, 2008
[6] Sherman, J. Andrew and Milledge A. Hart, *Mergers and Acquisitions from A to Z,* 2 ed. Amacom, American Management Association, NY, 2006

Determining the value of the target company. The purchase of a good at the best possible price requires possession of great ability and experience to negotiate. If it comes to acquisition then determining the value of the target company is one of the key moments in the process. Based on the determined value the bid price will be offered to the owners of the target company. And when it comes to a merger, companies need to determine the value of the companies before the merger. Companies who are interested in buying or merging with another company always strive to determine precisely the value of the target company, and thus to recognize the potential benefits of the merger / acquisition. So, the question of the true value of the target company takes considerable time and resources. Normally, the two parties involved in the process of evaluation have their arguments in defending their own position: the purchaser will seek to achieve as low price as possible, while the target which is sold will try to place as higher price as possible. Several methods are being used to determine the reliable price which represents the value of the company, not only for acquisition but also for the proper valuation of the companies that merge. They are generally systematized in the following three groups:[7]

1. Market-oriented methods;
2. Methods based on cash flows;
3. Methods based on assets.

The definition of the financial stability of the target company and its value is particularly significant issue, but it is not isolated by itself. Trends in the industry in which belongs the target company and the overall macroeconomic aggregates in the economy: investment, inflation, structural unemployment, the phases of the economic cycle and so on inevitably need to be analyzed. The main objective of this analysis is to get as much as possible relevant information for predicting future performance of the target company. Mostly practiced are the market-oriented methods as they are simpler to use, but even for them it is necessary to obtain correct information used as a basis for comparison. However, the combination of several methods can result in very reliable results. Which of them will be taken into account often depends on whether it comes to a merger or acquisition, the industry in which the companies belong, their size and so on.

Market-oriented methods. The application of these methods starts from the typical characteristics of the target company and compares them with the characteristics of similar companies that exist in the market. Companies that are used as a basis for comparison often have a predetermined market value that is known. The two most important starting assumptions are: 1) which characteristics of firms will be compared and 2) which companies will be used as a basis for comparison. It is easier to find an appropriate enterprise for comparison within the industry for listed corporations, while for small businesses and no listed companies finding a similar company for comparison is difficult. However, there are numerous national and regional databases for companies of this type, which can be used as a reliable source of information.

Characteristics of companies that are commonly used for comparison are:

- Operating profit, net profit, earnings per share;
- Total revenues and income from operations;
- Book value of assets.

[7] Rosenbaum, Joshua and Joshua Pearl, *Investment Banking: Valuations, LBO, Mergers and Acquisitions*, John Wiley & Sons Inc., New Jersey, 2009

It is characteristic to be noted that market-oriented methods of comparison use historical data. On the one hand this provides certainty in the valuation, but on the other it does not take into account future company performance that is particularly significant. The next are the most important indicators for comparison between companies:

- The Price/Earnings Ratio. After the calculation of P / E it is compared to the P / E of other similar companies in the industry, which gives information about its significance in determining the value of the target company. In determining the bid price for shares purchase, the buyer offers a price that is multiplied value of P / E, which is the price that is close to market value if the latter is set on a realistic base.

- Assets to Sales Ratio. As in the previous case, it is compared with A / S to other companies in the industry, then the buyer offers a bid price that is multiplied value of the sales' revenue or price which is close to the value of assets in the balance sheet if the assets have real book value.

Methods based on cash flows. The methods for companies' valuation based on cash flows take the time value of money in consideration when assessing the value of a company. So, input components in the calculations for these methods are the future cash inflows and outflows of the company and the determination of their present value. The result is: net present value of the company (NPV) or discounted cash flow (DCF). The value of the company is determined according to the level of these indicators.

Net present value is obtained as the sum of discounted future net cash flows:

$$NPV = \Sigma \frac{Ct}{(1 + r)\ t} \qquad (1)$$

Where: NPV = net present value of the firm
Ct = net cash flow in period t
r = discount rate
t = time of projection

The discounted free cash flow results when the net profits of the year will be corrected by the amount of interest, depreciation and gross investment in operating assets and then will be discounted with the average cost of capital WACC.

$$DCF = \frac{\text{Net income} + \text{Interest}\ (1 - \%\ \text{Income tax}) + \text{Depreciation} - \text{Gross investment}}{1 + WACC} \qquad (2)$$

If we analyze a time period of several years, then final DCF is the sum of each year separately:

$$DCF = \Sigma \frac{DCFt}{(1 + WACC)\ t} \qquad (3)$$

Where: DCF = discounted free cash flow
DCFt = discounted free cash flow in year t
WACC = average cost of capital
t = time of projection

The calculation of these indicators requires a sound knowledge for the financial situation of the company, so ultimately the result to be a relevant indicator. Since the formulas require input data for future cash inflows and outflows, the estimation of the exact size of these categories is particularly important for the validity of the final result. The existence of the probability as a component makes the calculation more difficult, but it does not mean that it reduces its value. With the help of modern information technologies, based on numerous analyses, quite accurate estimation of future cash inflows and outflows of the company could be carried out and thus relatively high accuracy in the results is being achieved.

Methods based on assets. These methods are commonly applied in cases where the target company operates with loss. In this situation, the estimation of the assets could be a sufficiently reliable method for the valuation of the company. Of course, if the conditions (resources and time) permit, you can combine these methods with some of the group of market-oriented or methods based on cash flows. The usage of the methods based on assets usually results with a relatively low value of the company being valued. However, these methods provide high accuracy in assessing the company, or real valuation of assets which the target company possesses. The suitable representatives of this group of methods are listed below:

- Adjusted book value of assets. It is an assessment of the company according to the book value of assets in the balance sheet, of course taking into account accumulated depreciation. Since the book value is a historical value, ie record of assets on the date of their purchase and determination of depreciation rate, it may not be consistent with the market value of the assets. Therefore, if judged as necessary, a correction of the book value is being taken to determine a more realistic value of the company. The main disadvantage of this method is the fact that it does not take into account the company's intangible assets (human resources, knowledge, skills, know-how, brand, etc.).

- Liquidation value. As the term says, it represents the value of the company upon its liquidation or closure. It is the value that remains available to shareholders after the sale of assets to cover all liabilities to company’s creditors. This method is commonly used in case when the target company works unsuccessfully for a longer period, creating a number of obligations towards its creditors, suppliers, banks, employees and so on. The aim is to determine which is the difference between the value of assets and liabilities of the company, and thus to decide to buy the company or to establish a new one.

- Cost of replacement (tangible + intangible assets). This method tries to determine the value of the company as the sum of the value of all the tangible assets (buildings, equipment, tools, supplies, etc..) and the estimated value of intangible assets. The logic is to determine how much it would cost to create a new company just such as the existing one, regardless the sources of funds, i.e. to replace the targeted company (hence the name of the method). The value obtained using this method is closest to the true value of the company, but it takes numerous information, experience and great knowledge in assessing the value of company’s intangible assets.

In addition to the concept of valuation of company's tangible and intangible assets occurs the moment of prediction of future synergy of newly formed company's activities. This synergy is the main reason that justifies paying a premium or higher price than the actual value of the company. The holders of shares in the target company would not want to sell their shares if they know that the future will bring high dividends and increased stock market value. To give away the future income shareholders must be compensated with sufficient current income. Actually this is one side of the justification for a higher bid price for the target company. And the other? If the buyer is willing to pay a higher price for the target company it means that he expects to achieve higher value of the company after the acquisition or merger than the simple sum of the values of the companies before that action. This is expected due to the synergy of activities as potential for greater success.

The following equation offers a very reasonable way to estimate the minimum required synergy needed for achieving the desired value of the company after the acquisition or merger:

$$\frac{\text{Value of the target firm before joining + Synergy}}{\text{Number of share after the merger/acquisition}} \geq \text{stock price before merger/acquisition} \qquad (4)$$

It is clearly seen from the equation that the acquisition or the merger is justified only when the value of the shares of the two companies after accomplishing the merger / acquisition is greater (or at worst equal) than their value earlier. The synergy is the potential source of increased value. However, not all acquisitions and mergers end up successfully and not the market value of the shares grows so fast. If the achieved level of synergy does not correspond with the expected and companies do not achieve the planned objectives, the market in modern economies quickly punishes and rewards, otherwise.

Conclusion

It is difficult to determine in advance how much mergers or acquisitions will be successful. The burden of expectations is usually carried by the target company – whether it really holds the value assigned by someone. One more thing, how many companies fail to truly integrate and create synergistic value is an issue that gets the correct answer after things are done. To identify potential successful M & A, investors and managers should observe the following simple criteria:

• A reasonable sales price. For example, 10% premium over market value is quite justified, but 50% premium requires an amazing synergy of actions in future operation, in order to justify the high selling price.

• Cash payments. When M & A are financed with cash all parties act more carefully in the process of evaluation and determination of the sales price, conversely, in case stocks issue or bonds everyone is somehow relaxed.

• Moderation. The buyer has to assess its capabilities to purchase the target company without overestimation. Sometimes, due to increased appetites companies "bite a piece which they cannot swallow".

There are two basic imperatives that must be prominent in any discussion of international mergers and acquisitions. First, companies engage in activities or undertake a merger to create value and that value is born through a combination of synergy (which decreases the costs) and appropriate competitive strategy (to increase revenue and growth of the company). And second, the goals and synergies of the competitive strategy cannot be achieved without careful attention to the process of integration of the companies. To realize the potential of an international merger or acquisition and to justify the high premiums paid by most companies, top managers need to accurately understand and implement the method of selection and evaluation of the target company. You just have to know what you want to buy, what you are being offered and how much does it worth.

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