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EFFECTIVE SCHEMES OF FINANCING MERGERS AND ACQUISITIONS OF INTERNATIONAL CORPORATIONS

Vladimir Momot*, Vyacheslav Makedon**

Abstract The article considers the question of a choice of the optimum scheme of financing mergers and acquisitions (M&As) in the environment of international corporations. Methods and ways of financing integration transactions are considered and key factors and system processes of realization of these transactions are defined.

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Introduction

At the present time many international corporations have appeared in a situation in which an M&A is a beneficial element of strategy of future development. Here is the analysis of the most important practical aspects of carrying out and financing such types of transactions to reveal what exactly from the accumulated international experience appears to be the most effective for corporations in different countries.

By means of mergers as an external way of development the corporation provides conformity of its activity to the chosen concept of development. M&As possess a variety of advantages in comparison with internal methods of corporate development. The core, which is serving at the same time as the main motivating factor to carrying out an M&A, is the effect of a synergy which is expressed in the creation of additional value.

Problem Definition

The basic problems of carrying out similar procedures consist in the choice of a source of financial resources and performance evaluation of the M&A which is achievable only at increase in well-being of shareholders and use of competitive advantages. It is necessary to pay special attention to this as among recent M&A transactions the share of unsuccessful and inefficient transactions leading subsequently to the disintegration of the united corporation is significant.

In most cases of corporate M&A it is necessary to carry out preliminary serious work on the estimation of corporate value and the definition of possible synergetic effects from a merger. Therefore problems of the estimation of corporate value become now more and more significant and demand special consideration and study. Issues of M&A management and also development and realization of techniques of their financing are stated in works of such known scientists in this area of the international business: Child, Faulkner and Pitkethly (2001), Denis and McConnell (1986), DePamphilis (2009), Gaughan (2010), Hamilton, Hill, Knirsh and Zalesky (1986), Pautler (2003), Reed and Lajoux (2007), Rock, Rock and Sikora (1994), Trautwein (1990), Vachon (2007), and Warshawsky (1987). At the same time

* Sc. D in Economics, Professor Vladimir Momot, Alfred Nobel University, Naberezhna Lenina st. 18, Dnipropetrovsk, Ukraine, vmomot@duep.edu.

** Ph. D in Economics, Associate Professor Vyacheslav Makedon, Alfred Nobel University, Naberezhna Lenina st. 18, Dnipropetrovsk, Ukraine, makedon@pisem.net.

organizational and institutional processes of a substantiation of participation in financing and a choice of a source of M&A financing demand further research.

The purpose of this article is the organizational-economic substantiation of choice and performance valuation of a source and scheme of M&A in the environment of international corporations.

These circumstances cause the necessity to research the ways of raising funds for an M&A on the basis of modern foreign experience and to select from them those most corresponding to the activity of enterprises under real conditions.

Problem Solution

Forms of funding for mergers are very different. In these purposes all tools of the financial market, both money resources, and bonds, up to a various sort of combinations of securities can practically be used. Financing of the operations which are connected with corporate decisions on M&A largely defines how the transaction will be carried out. The choice of a source and scheme of financing directly defines the financial leverage of a corporation from the purchasing side.

The basic problem in the issue of M&A financing is an issue of repayment of the funds invested. This cornerstone of all financial questions began to attract more attention recently in connection with failures which are more often beginning to occur with this type of transaction. On the agenda there were two widely discussed questions which are very similar in content: how to determine whether the additional value will be created as a result of acquisition, and what factors can lead to a failure of the transaction (Dennis & McConnell, 1986).

It is necessary for the participants of an M&A to define the amount of financing required. For this purpose it is necessary to indicate all operations of the transaction and their cost for the corporation, and also to update taking into account all factors which are capable of affecting the cost of one or another operation. To define the size of necessary financing, three primary questions need to be clarified:

Firstly, it is necessary to estimate the value of the business acquisition, including:

1) the price of a share holding and/or assets of the acquired corporation (in case of payment by money resources, it is necessary to identify clearly what changes can occur with the corporation's cash flow, and what inflow of means can be generated by the sale of assets of the acquired corporation),
2) amount of existing debts which should be accepted and paid by the buying party,
3) administrative and/or tax costs which are associated with the transaction of a buy-out,
4) the expenses which are required for consultants and intermediaries in carrying out the transaction (accountants, valuators, investment bankers, lawyers, and others) (Rock, et al., 1994).

Secondly, it is necessary to estimate how much will be required after acquisition for the functioning of the new (or united) corporation, including:

1) the requirement for working capital on a near-term outlook,
2) payments on settlement of judicial lawsuits and payment under claims (if found while researching),
3) planned investment expenses (current replacement of equipment).

Thirdly, required is valuation of business expansion after the corporate acquisition, including:

1) the future capital investments for provision of growth,
2) marketing expenses (market research and market expansion) (Rock, et al., 1994), (Warshawsky, 1987).

The method of payment from profit does very well, if the acquiring party wishes to utilize excess money resources. From the point of view of shareholders of the acquired corporation, the offer from money resources has an advantage. It is defined by a concrete sum and the shareholder can either reinvest or use the proceeds, without having to sell the shares and to incur the expenses for the performance of this operation. However, it has a disadvantage. There comes a tax obligation on profit from capital increase. When the acquisition is paid out of profit, the risk applied to the estimation of the acquired corporation decreases by linking all or part of the consideration of the purchase with profits after the estimation. This method is used to reduce the cost of initial financing through the payment of a part of the counter-claim from profit.

I. Participation financing.

The main advantage of joint-stock companies in comparison with other management types is the use of the mechanism of the shares issue that allows, on the one hand, to concentrate quickly considerable financial resources for the realization of large investment projects, such as M&As, and on the other hand, not to be bound with the excess obligations in the form of loans. Herewith, investors risk only within their share in the authorized capital if worsening of the financial condition of the issuer occurs. For the issuer's corporation the basic disadvantages of such a way of financing are the threats of counter absorption by aggressively adjusted investors buying up shares (for example, by "the white knight" who is protecting the target company), capital wash out (if the former shares preservation in the share capital hasn't been provided), strengthening of corporate control from the stock market and people wishing to participate in management (Child, et al., 2001).

The advantages consist in the optionality of the current payments for all types of shares, in the possibility of carrying out a flexible emission policy which helps to control the share capital structure through the creation of a financial product that combines in one issue the most various kinds of shares.

The main thing for a joint-stock company (JSC) is the use of the mechanism of the issue of securities. In its turn, issues of shares can be classified by the following features:

1) by the sequence of issues (primary and secondary (only for a Public Corporation),
2) by the type of securities issued,
3) by the location mode (distribution, subscription, conversion),
4) by the subject of accommodation (on its own or by an underwriter),
5) by the volume of the issue (with registration of the prospectus of the issue or without it),
6) by the financial sources of issue (at the expense of their own means or means of the shareholders),
7) by origin of investors (founders, foreign investors, external investors of mixed origin) (Vachon, 2007).

Herewith, placement by the subscription can be open (a public issue when registration of the prospectus of the issue is necessary, it is valid only for a PC) and closed (private placement). Public placement provides a more sufficient disclosure of information, under the one – the procedure is considerably simplified, because it is designed for enough qualified investors who are defined with risks, connected with purchase of shares of the issuer. The way of private placement is more real (especially for securities of "the second tier") as it is possible to find an investor who is really interested in share purchase of this very issuer and not just players of the stock market. Thus, the advantages of private placement have a high probability of getting the highest price for a concrete security, concentration of shares among the profile investors for whom the long-term stability of the issuer's financial position and the increase of his competitiveness in the market will be favorable. Placement as specified above can occur by conversion. The issue of convertible bonds finally leads to the appearance of a number of new joint-stock company shareholders.

II. Debt financing.

The growth of acquisitions at the expense of borrowed funds has received a new impulse as a result of a break with the large conglomerates which were popular in the 1960-70s. Many large corporations find out that some kinds of their activity no longer correspond to their current strategy, and therefore they aspire to encourage local management to repayment of the parent corporation. Management buyouts (MBO) are usually leveraged buyouts as administrative teams usually do not have enough personal resources. However, management of the buyout corporation is not necessarily a team gathered to take shareholders out of the parent or other corporations. Various external groups of investment banks, owners of the risk capital and experts in a certain branch can unite for the buyout. Usually this operation is based on the confidence that its participants can improve considerably the performance indicators of the corporation and make then sufficient means for repayment of the debt that was made for acquisition of the corporation. This type of transaction sometimes is called a purchase under managing directors (Reed & Lajoux, 2007).

The statistics show that the indicator of failures in leveraged acquisitions is about one fifteenth whereas among newly opened enterprises almost every third suffers failure. Therefore, in spite of the fact that usually these operations appear successful, leveraged acquisitions carry higher risk compared with the usual acquisitions that are financed by a traditional combination of loan and equity capital as loans used in transactions are based on the acquired corporation and are repaid from its cash flow. In other words, the buyer can use the money borrowed under the assets of the acquired corporation (though with some restrictions) to provide a part of the transaction price paid by money resources. Besides, no matter how strange it may seem, the loan possibilities frequently appear better at the acquired

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corporation as they weren't used because of careful management or because the corporation has no need for additional funds. Actually, a corporation having bigger possibilities for potential financing than the purchasing-corporation, more often becomes an object of acquisition. A powerful wave of leveraged acquisitions occurred in the second half of the 1980s in the USA. It, mainly, was connected with the development of tools for long-term financing, namely highly lucrative, or as they are often called "junk bonds".

The basic motive for "leveraged buyouts" is the belief of the initiators in the possibility of a significant increase of corporation market value as a result of restructuring, reviewing of market strategy, and considerable growth of operational efficiency. After due transformations and increase of a corporation's value owners can sell their stake. Extremely high returns on the invested capital for initiators of "leveraged buyouts" in case of success can be explained just by using the borrowed funds for financing the operation (Hamilton, et al., 1996).

In the simplified variant a leveraged buyout scheme of an MBO can look as follows: managers of the corporation do the tender offer and as soon as it becomes clear that the existing shareholders will offer to sell a significant number of shares, they will organize financing. Usually at purchase on borrowing initiators of the transaction put up about 10% of the total amount of cash, and these funds become a basis of the share capital of a new corporation. Managers also receive a package of options for shares that in future will provide an increase of their package under the condition of successful development of corporation. Another 50-60% required for acquisition are gained as the provided banking loan. The assets of the corporation act as collateral. The remaining 30-40% is received by releasing "junk bonds". These bonds are highly lucrative, yet risk is very high, as they have a low level of provision. At the following stage of the transaction, management, having mobilized resources as described above, acquires all shares of the corporation and thus, the total control. To sink a part of a debt, either parts of assets or separate divisions of a corporation are sold (DePamphilis, 2009), (Institute of Mergers, Acquisitions & Alliances, 2012).

Under management buyout there is some support from the owners of the capital, ready to risk, as well as from the investment banks. To have any chance for success at MBO (as a leveraged buyout), the presence of all or some of the following conditions is necessary:

1) reliable stable profit during the previous periods,
2) predictable cash flow,
3) a strong, reliable management team,
4) clearly defined niche in the market,
5) reliable collateral in the form of fixed and working assets,
6) not to be capital-intensive,
7) not to demand any large investments in the capital and infrastructure in the near future,
8) not to grow too quickly,
9) to have a definable potential of profit growth and cash flow (DePampilis, 2009).

As a rule, banks or professional specialized funds which are often united in pools act as creditor. But there are also exceptions. Sellers can help to sell their corporation, having agreed on payment of the transaction by securities. For example, consulting agreements can be used for financing transactions on sale of corporations. There are also other forms similar to consulting agreements: royalties, annual remunerations to the management of corporation and even research work in technological corporations.

The seller can even finance sales by his own funds, in this case this type of financing goes back to the usual crediting of acquisition provided with the assets of the acquired corporation.

Venture funds invest the capital in small private corporations with a high rate of growth. In this type of financing the emphasis is on management quality of the acquired corporation. These investors demand a stake in a corporation.

Buyers often prefer to involve as much as possible borrowed current assets for financing an M&A of a corporation. One of the basic advantages of debt financing, instead of a stake, is tax benefits, of course. There are interest payments on a debt, at the same time in the given scheme there are no dividend payments on shares (in a united corporation).

However, the fact is that when a national economic recession occurs, or an unexpected crisis arises, the position of a borrower cannot be extremely favorable. Before agreeing on debt financing of merger or acquisition, the buyers of a corporation should define how expensive it is going to be. It is possible to offer some recommendations for buyers of corporations, which are necessary to use to make sure that they

do not borrow more than they can return without serious consequences. There are financial factors allowing buyers to avoid difficulties (Gaughan, 2010). First, there is a coefficient of debt coverage. Creditors use some factors and formulas to measure the ability of a corporation or a private person, to repay a debt. The ratio of interest coverage is most widely used. The formula for its calculation is:

$$B_c = \frac{E_i}{W_e} \tag{1}$$

where: Bc = coefficient of interest coverage
Ei = earnings before interest and taxes
We = charged interest

This ratio serves also as an indicator of a corporation's ability to take additional loans. Creditors have an opinion that the income before paying interest and taxes should be several times more than the charged interest as they are paid before tax from corporation profit. Some contracts of debt financing include the requirement of a certain value interest coverage ratio (Trautwein, 1990).

Secondly, it is necessary to make sure that in the long-term plan the cash flow of the corporation is stable. Under term loan use, free cash flow is capable of showing the solvency of corporation. The ratio of debt coverage is used for this purpose:

$$B_a = \frac{D_f}{W_e} + F_{gh} \tag{2}$$

where: Ba = coefficient of debt coverage
Df = free cash flow
We = charged interest
Fgh = principal amount of debt

However, frequent assumptions that all cash flow available to a corporation is accessible to a cover debt are considered to be mistaken. Therefore, this coefficient shows, in what measure the given cash flow promotes debt service. Creditors consider,that the ideal value of a coefficient makes 2 to 1, but in practice over the past few years the majority of the enterprises show the change of this indicator for the worse.

Once again, there are questions of the quality of the estimation and forecasts made. Buyers should estimate how the present stable positive cash flow will look after some time or another. There are rules defining feasibility of obligations upon the company's debt which use borrowings for financing an M&A (Vachon, 2007):

1) To use debt financing for the creation of higher profit. Even if the corporation has positive cash flow, the buyer should use debt financing under the transaction for the increase of the efficiency of corporation, its net profit growth after the transaction to pay expenses on debt service, without worsening the financial position of the corporation and without losing possible benefits from the effect of synergy.
2) To ensure that all assets of the corporation generate profit. Unused equipment, worked off either excess inventory or unnecessary corporate real estate should be sold to receive funds to settle the debts. A ratio 80/20 (Pareto rule) according to which only 20% of any assets generate 80% of the total result. According to this rule, there is sense whenever possible to change the remaining 80% in order to try to raise general efficiency.
3) To coordinate payments on a debt with cash flow of the acquired corporation. Insufficient synchronization of payments on a debt with cash flow of the corporation can whittle away all attractiveness of the transaction. The buyer should make the big payments on the basic sum of a debt, while his expenses on operations will be high. After all, without "a crystal ball" it isn't possible to forecast future crises or successes of the acquired corporation, but it is quite reasonable to make a plan of debt payments according to a projected cash flow.
4) To plan higher expenses on interests If with a view to financing the transaction the buyer uses a loan with a floating interest rate, it is necessary to estimate prospects of the transaction for the scenario with a balanced interest rate and a scenario with the greatest possible rate.
5) To apply tactics of alternative financing. The use of several sources of financing allows a softening of a policy of payments; it is better to adapt it to the cash flow of the corporation. The detection will be easier, if the buyer isn't desperate. If the buyer sees, that assumptions of the rate, terms or size of a loan were mistaken, it is necessary to restructure the loan with the same creditor or, in case of necessity, to get financing from other source.

III. Other forms of financing.

Buyers can use various financing strategies and, choosing between them separately or in a combination, adapt methods and terms of payments, having minimized the interest rate, commission or other obligations by a loan.

1. Change of the ownership structure.

A separate category in the activity of M&As is the operations leading to change the property structure and the control over the firm. Those are transactions of transformation of a public corporation into a closed corporation or into a partnership when all shares are bought by a small group of investors. In some cases they take the form of "squeezing" when the participation of small shareholders in a corporation is eliminated. This operation can be done by offering the shareholders to exchange ordinary shares for preferred stocks or bonds. The other way is just the company's buyout of a part of its own shares in circulation. Transactions on transformation of a public corporation into a closed corporation are often made with the use of considerable loans (Pautler, 2003).

2. Joint enterprises and business separation.

The notion of M&A includes also various methods of separation of the enterprises or industrial divisions. The sale of a part of a corporation includes two principal views: "bidding" and the sale of separate divisions. As a result of "bidding" a separate legal entity is formed, an affiliated corporation in which shareholders of a parent corporation receive a share in proportion to their share in the parent corporation. As a result of such a transformation the parent corporation does not receive funds, but shareholders have an opportunity to sell their shares in a new structure. This way also provides for loans for the balance of a new structure.

There is a kind of selling called "the breaking of the corporation" when the parent corporation as a result of a number of "biddings", is divided into some corporations, and in itself it ceases to exist. One more variant of "bidding" is a branch when a part of the shareholders of the parent corporation receive shares of a new affiliated corporation in exchange for the shares of the parent corporation and thus, two groups of shareholders are formed.

The sale of subdivisions, or, divestment, means the sale of a part of a corporation to a third party. As a result, the seller receives a cash or equivalent compensation. There is a kind of divestment, called separation when a part of shares of any subdivision of the affiliated corporation is offered for sale to the public.

There can be plenty of schemes of sale or separation for the purpose of getting a financial return, as they are developed for each transaction to consider the interests of different groups of participants, and also to minimize taxation.

3. The plan of exclusive use of the share capital by employees (ESOP).

More often the plan of exclusive use of the share capital is used by employees in addition to management buyouts, and allows employees to buy a share of a corporation. A commercial bank providing funds for the purchase of the corporation acts as creditor. The acquired corporation guarantees the loan and makes annual stock transfers to a group of buyers following the loan repayment. Difficulties in the given form of financing are caused by the complex regulation of activity which usually demands professional administration.

4. The mechanism of reverse takeover.

An attraction of financial resources by domestic corporations through the mechanism of reverse takeover among American publicly-traded corporations is that it is the shortest way to receive investments for its own needs (including transactions on purchasing other corporations). For domestic corporations it is a good path to high-grade participation in the stock markets and for a possibility to attract additional capital at the expense of a secondary issue. It allows the Russian enterprises to enter the American stock market within several months at small expenses (Child, et al., 2001).

The essence of the method used is in an exchange of the equity capital between the operating international company and the American publicly-traded corporation which has been burdened neither by debts nor lawsuits and which submits all current reports to the US Commission on Securities. A similar American corporation has a certain number of market-makers who work with its shares listed in over-the-counter systems.

The reverse takeover mechanism itself looks as follows:

1) The corporation management arrange an Extraordinary General Meeting of shareholders to make a decision on the additional issue of shares increasing their quantity in several times so that the share of primary owners is reduced to the necessary size (it is the sale price of the publicly-traded corporation's status).

2) After releasing the additional issue, the corporation is taken over by another company by share exchange. Some quantity of shares of the American corporation goes to the investment-banking group acting as an intermediary in this transaction, as a compensation for its services. As a result an intermediary becomes directly interested in the further promotion of the corporation formed as a result of the merger.

3) Together with the takeover the former Board of Directors and corporate management resign and are replaced by the shareholders of the buyer-corporation or its representatives. Thus, the holding is formed completely controlled by the owners of the buyer-corporation who own majority interest in the American corporation.

4) Further the technical aspects of the merger are carried out, which are expressed in the conformity of accounting and financial documents of the corporation, which is formed as a result of the merger, according to its new legal status. After internal documents accept the consolidated form, the corporation, whose shares are publicly traded in the US stock market, represents assets in its reports as well as earnings and profits of its foreign structure.

5) As a result, shares of the American corporation (now supervised by the primary owners of the foreign corporation) continue to be quoted in the stock market, which allows them to attract capital as now these shares have received new significance.

One of the main advantages of the reverse takeover as a way of financing an M&A in comparison with the release of American depositary receipts is the circumstance that the owners of the buyer-corporation will have an opportunity to "water down" the capital, i.e. to receive some shares of the American corporation for one. Thus, the buyer-corporation now possesses a powerful source for strategic development which is in the possibility to take over other corporations, offering the shares of controlled American corporation in exchange. The way of reverse takeovers will also allow them to attract additional capital at the expense of a secondary issue that is carried out by the American corporation much more easily than to make a release of American depositary receipts of the third level where there will be a number of rigid restrictions.

Conclusion

In the article a review and the analysis of traditional methods of financing M&As have been done; approaches to both transactions which create additional value for the united companies and possible methods of their financing have been considered. On the basis of the analysis it is necessary to draw a conclusion on the necessity, in some cases, of using new approaches in the choice of the scheme of financing an M&A and if possible to use a method of reverse takeover to attract financing in the international markets. The article gives a detailed analysis of the theoretical bases of each method and specifics and constructs their advantages and drawbacks.

The analysis of the financial model of M&A efficiency within the framework of traditional methods of value definition have been considered and also a method of actual created value. Practical recommendations as for the efficiency of M&A have been offered.

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