Book 3, chapter 4

STRUCTURING MERGERS AND ACQUISITIONS

A joint paper by Toyin Munis and Dick Kramer for the Seminar on Mergers and Acquisitions organised by NAL Merchant Bank at Nigerian Institute of International Affairs on Thursday, May 11, 1989.

Mr. Chairman,
Distinguished Ladies and Gentlemen,

The last few years have witnessed a flurry of mergers and acquisitions in the developed economies. Several factors have been identified as responsible for the trend. This morning, we will seek to identify some of these and relate them to Nigerian circumstances. The Nigerian economy has, in fact, reached a critical stage which will likely generate considerable future merger and acquisition activity. SAP (Structural Adjustment Programme) is causing fundamental restructuring throughout the entire public and private sectors. Great strides have been taken in stabilizing the Nigerian economy and laying the foundation for eventual future development. However, there is no quick fix in sight. Global oil markets promise to recover slowly while supply/demand forces continue to ensure unpredictable foreign exchange earnings. We realize that funds to stimulate growth are going to be hard to come by. Despite truly heroic efforts, the major economic forces at work are largely outside Nigeria's control, hence substantially irreversible. Hard work and a realistically valued Naira are needed for systematically developing our non-oil exports as additional sources of hard currency. While debt restructuring will provide breathing space, realistic debt management still depends on strengthened fiscal and monetary discipline plus renewed growth in the overall economy. Investment itself - the source of economic growth - must be attracted and this involves the laborious and long term process of building a favourable investment climate.

Management in both the public and private sectors face the 1990's with an increasing need to plan for survival and to reposition their businesses in the light of a slow recovery but one that is hopefully sustainable based on the fundamental change which SAP has set in motion.

In our forecast for the future direction of economic activities, one inevitable result will be the pressing need to make existing assets work more productively and this brings us to today's topic. Management will increasingly turn to mergers and acquisitions as a useful tool in this battle to survive, to use existing assets effectively, and to build sustainable competitive position. Practical reasons for this conclusion are readily apparent:

- industry overcapacity and too many players in some industries (the Softdrinks and Alcoholic Beverages)
- integrating backwards toward local supply or forwards toward stronger distribution
- availability of underutilized assets which are costly to import
- excessive debts or lack of funding capacity for sellers vs excess cash and strong financial position for buyers (sometimes as a result of CBN policies)
- specific circumstances such as under capitalization, debt/equity swaps, blocked funds, etc.

This change will not happen without some pain and it will be a learning process. Successful mergers and acquisitions do not happen, they must be planned and executed effectively.

If our forecast proves correct, relevant skills and experience will need to be developed by both buyers and sellers and the market for outside services will also prosper - primarily among banks, lawyers, accounting firms and management consultants. Highly developed technology and practices from active merger and acquisition markets abroad will become increasingly relevant and the process of tailoring proven approaches to Nigeria can be expected to occur. All of this should put pressure on legal, accounting, tax and regulatory structures and practices to change and to accommodate future market requirements.

Lastly, and perhaps most importantly, we should see increased scope for both entrepreneurs and professional managers to play an expanding role in Nigeria's future economy.

Given the above context and outlook, our paper will focus on three areas -

(1) Key factors for planning and implementing successful mergers and acquisitions;

(2) structuring successful deals which includes financing, tax planning and accounting issues and

(3) major issues which impact and/or constrain the current Nigerian merger and acquisition scene.

PLANNING AND IMPLEMENTATION

Mergers and acquisitions have been on the business scene since the industrial revolution and, as economic fortunes change, we observe significant variations in activity levels and constantly changing practices and funding techniques. Nevertheless, there are basic fundamentals that have stood the test of time and we can think of as key success factors.

The importance of these fundamentals can be better judged in the light of several studies which show high failure rate in both mergers and acquisitions. In these studies, failure has been measured in terms of whether mergers produced sustained increase in earnings per share, achieved the specific merger objectives, and enhanced overall buyer reputation and strategic purpose.

Failures are frequently attributed to excessive price in relation to underlying market value, lack of sufficient financial resources, inability to achieve economies of scale or expected synergy, incompatibility of buyer and seller managements and cultures, unexpected economic or regulatory developments, etc, etc. These reasons for failure, however are more symptoms than causes since the underlying causes of merger failures are virtually all traceable to management. The primary cause of failure is either disregard or failure to appreciate the complexities of mergers, combined with a tendency to relax or not follow through after the deal takes place.

Clearly, those who plan systematically for mergers and acquisitions, execute the deal structuring effectively, and pay great attention to post-merger implementation turn out to be the winners in the merger/acquisition

How do you ensure success?

Our approach is the adoption of a three phase process, supported by a comprehensive methodology, to assist management in thoroughly and systematically carrying out each important merger activity or step. The three phases are -

(1) planning - which links with overall long term or strategic planning.

(2) company investigation and deal structuring - which focuses on a specific candidate from initial analysis through to finalization of a specific deal.

(3) merger integration - which deals with all the complex post-merger activities needed to implement and sustain a successful deal.

The three phase process is applicable to either buyer or seller, although obviously a company making systematic purchases and divestitures will acquire considerably more expertise than the typical seller who builds a business over a lifetime and its sale is therefore a single life event. What is important for today's purpose is to recognize that there is a methodology, or process, which leads to successful mergers and acquisitions for either buyers of sellers.

We will briefly spell out the fundamentals for each phase before commenting on overall "success factors".

The planning phase deals with the overall business or corporate strategy with emphasis on developing an acquisition (or divestiture) strategy within the context of overall mission, objectives and goals. Such framework can then be converted into screening criteria that provide quantitative and qualitative factors to screen target industries and companies for acquisition (divestiture) potential. Within target industries, high potential companies are selected and in-depth analysis carried out to evaluate proper fit with overall corporate plans as well as preliminary evaluation of the prospective candidate. Planning is an ongoing process and rigorous screening means that typically few candidates proceed to the next phase.

The second phase starts with a company investigation, which typically proceeds in parallel with deal structuring, and provides the basic information for evaluation, structuring and negotiating the final deal. Investigations can be at various levels of detail and may start with a brief "businessman's review", then involve a full purchase investigation and/or audit, finally winding up with detailed valuation studies. The degree of depth, of course, is tailored to the requirements for structuring the specific deal and depends on the degree of meeting of the minds between buyer and seller.

Deal structuring takes place only if both parties show serious interest and typically include the following activities:-

- negotiating and establishing a purchase price based on valuation methods, financial projections, and other factors
- structuring the deal from financial, tax and accounting viewpoints; for example, cash vs paper, payment terms, leveraged buyout, purchase of assets vs shares, etc.

- financing the transaction
- negotiating other aspects of the deal such as strategies of the surviving company, employment contracts, covenants not to compete, employee benefits, the integration plan itself, etc.
- drafting the acquisition agreement
- closing the deal.

Merger integration activities (the third, final and crucial phase) largely deal with successfully combining product or service lines, physical facilities, distribution channels and supplier sourcing, marketing and product development activities, organization structures and management staffing, and two different corporate cultures. Obviously, considerable change also occurs in policies and procedures, accounting and reporting systems, data processing, etc. Most merger/acquisition failures occur due to failure to anticipate, plan for and implement this third phase. Three primary lessons seem to emerge -

(1) the large company (particularly if diversified) needs to fully understand the smaller company and what makes it tick. Management of diversified companies is inherently difficult particularly since different technologies, production processes, distribution channels, marketing methods, and financial/economic practices are required for different industries and businesses.

(2) similarly, large companies tend to adopt a belief that bigger is better thus becoming acquisition hungry in search of growth. In reality, sustainable growth requires a competitive advantage and this is more a matter of products, value in relation to price, people and service levels rather than size.

(3) lastly, large and bureaucratic companies tend to fear obsolescence and believe acquisitions will revitalize through infusion of new blood. Most frequently, the senior partner in a merger adopts a condescending attitude and smothers the junior partner in bureaucratic controls. This lack of understanding of the small company culture frequently results in turnover of good people and a "hollow" acquisition which pleases neither buyer or seller nor the society at large.

Successful mergers therefore depend on several key success factors including -

- a deep commitment to manage change - particularly the human and cultural aspects which preserve organizational value and create synergy.
- effective planning and execution of the merger itself - what we call merger integration and which so frequently depends on the right parent leadership, clear and not overly complex reporting relationships, and deep understanding of the newly acquired business leading to selective and synergistic changes.
- linkage of the merger closely with parent strategies and above all ensuring that necessary resources (technology, people, and funding) are made available.

Note that management's tendency to focus on the deal and then relax must be avoided. The really creative and most critical part of any merger is the implementation itself.

The overall conclusion is that merger success or failure depends on management quality. "Good" management develops merger strategy in the context of the company's long term development; investigates in-depth and converts only opportunities into properly structured deals; avoids psychological pitfalls common to large companies; and goes to great pains to manage the merger through to successful integration. "Bad" management tends to be opportunistic and emotional and follows no logical process at all. Pre-merger planning and execution coupled with post-merger followthrough turn out to be the hallmarks of quality managers who make mergers work.

STRUCTURING THE DEAL

Each deal is unique and must take into account the specific circumstances. First priority is to identify buyer and seller objectives before structuring the deal. Typically, these objectives are in conflict and not fully disclosed, frequently because they are driven by financial, tax, accounting and other less tangible consequences of the proposed sale or purchase.

Buyer objectives may emphasize minimum up front cash outlay, tax considerations favouring purchase, avoidance of contingent liabilities, reduction or elimination of potential competition, etc. Seller objectives, in contrast, may emphasize tax minimization or deferral, maximum cash flow, redeployment of funds and people to new ventures, etc. Generally, deal structuring requires a thorough understanding of both buyer and seller objectives, in order to reach "tradeoffs" which lead to the final negotiated deal.

Financing:

Financing the deal can be done under four main methods. These are -

1. Exchange of shares
2. Use of excess cash
3. Earn-out or note to seller
4. Borrowing

We have set out the pros and cons of each of the methods in Appendix A. These methods have been fairly tested in the developed economies and form the basic financing structure for most merger and acquisition transactions. The chosen method will be modified to recognise both buyer and seller objectives and also recognise the tax implications of the transaction.

Tax Planning:

The key tax issue will be to decide whether to structure a transaction as a tax free or a taxable transaction for either party.

Exchange of Shares:

A tax free business combination occurs through exchange of shares coupled with continued direct or indirect equity participation in the acquired company by the seller or its shareholders. Among the many advantages, the seller's gain on sale is not currently taxable and his continued interest in the buying company may appreciate in value free from income tax. The buyer benefits primarily from the continuation of the seller in the business, including a probable lower net cost due to the favourable tax treatment of the buyer. This scenario describes several of the merger transactions which have taken place in the Nigerian market viz: John Holt Limited and John Holt Investment Limited. Lipton and Lever Brother. Where the seller is not prepared to continue equity participation (e.g. insists on cash or equivalents), then the transaction will be taxable.

Use of excess cash:

Taxable transactions therefore involve cash or non-equity consideration with the seller having little or no continuing equity participation in the surviving company. Taxable transactions frequently better meet seller/buyer objectives. The seller may take a loss on sale which creates a tax benefit or not be interested in equity ownership of the buyer's shares. The buyer may benefit from avoiding dilution of earnings or ownership control. A variant of this structure is the recent sale of major business assets of a division of John Holt to 7UP where effectively the soft drinks business of John Holt was completely span off.

A combination involving both stock exchange and cash may result in a partially tax free transaction.

Earn out or Note to Seller:

When seller and buyer disagree on growth potential and therefore sales price, it is common globally to structure an earnout deal whereby cash or shares issued are increased if earnings exceed agreed levels. Such deals are quite attractive, where the seller wants to continue, because the seller may be best able to get maximum performance and to protect his own contingent interest while assuring the buyer of a smooth transition and continuity.

Contingent deals are difficult to structure in an unpredictable economic environment (high inflation, fluctuating foreign exchange rates, uncertain regulatory rules, etc.) and tax considerations must be carefully studied.

Borrowing:

Cash vs "paper" also becomes an issue between buyer and seller, depending on cash requirements and the quality and liquidity of the buyer's paper. Sellers can, however, benefit from accepting "paper" by increasing the number of potential purchasers and sales price, by non-taxable structuring of the deal, by providing seller with a high yield investment, and, if preferred stock is used, creating a preferential, lower risk position vis-a-vis common equity holder. Conversion, participation or other equity features may even permit seller to benefit from future appreciation of the underlying common stock. Furthermore, if marketable stock is received in a non-taxable transaction, the seller can plan when he sells thereby spreading the realization of capital gains over several years.

Cash sales remain simpler to understand and remove the risks of non-payment, future investment performance of the buyer's "paper", and quality of successor management.

The increasingly popular management or leveraged buyout (LBO), features increasing use of 'paper' since the purchase price is funded primarily by lenders rather than by the buyer. Hence the seller receives cash while the buyer (management) puts up little cash and largely "paper". Such transactions are highly complex since they involve additional participants (management, lenders and equity investors), each of which must be satisfied with the transaction. LBO's are evolving and expanding in the U.S. and Europe because lenders are increasingly basing financing on cash flow rather than asset collateral value thereby making this a viable option for businesses having high cash flow but nominal physical assets. The LBO technique normally introduces high debt service burden which must be met from operating cash flow. The seller has the choice of retaining partial equity interest and thus flexibility of timing when to "cash-out" versus sharing future appreciation in "paper" value. Nigeria's tax treatment, as well as a "paper" market, will need to develop before LBO's become popular.

Accounting Issues:

There are a number of accounting considerations which impact the merger and acquisition field. The principal problem will revolve around the definition of purchases versus merger accounting. Nigeria as a member of the International Accounting Standards Committee (IASC) follows those accounting standards issued by the IASC. where local standards have not been established. As a result, we follow IAS No. 22 - Accounting for Business Combinations, which deals with accounting for business combinations and treatment of any resultant goodwill. IAS No. 22 establishes two accounting methods for business combinations - the purchase method and the merger method. Briefly -

- the purchase method accounts for the acquired enterprise by applying the same principles for normal purchase of assets. It is always used for acquisition accounting and may be used for mergers.
- the merger method accounts for the pooled enterprises as though the separate businesses were continuing as before, though now jointly owned and managed. As a result, only minimal changes are made in aggregating the individual financial statements.

Merger accounting is clearly very attractive for the buyer and, while its use is carefully circumscribed by accounting standards, may easily make the difference between a successful deal or failure. Let us therefore look closely at the difference even though, as we shall see, merger accounting is not yet legal in Nigeria.

The purchase method values the consideration given (cash or shares) at market value and any excess over book value of assets acquired is treated as goodwill. Goodwill is either amortized over an appropriate period (thereby depressing future earnings) or written off at acquisition against shareholders' funds. As a result, the retained reserves of the seller are lost in the acquisition accounting and the combined group shows no more shareholders' funds than before the acquisition.

The merger method reaches a far more beneficial result. Shares issued to the seller are valued at book value of assets acquired. No goodwill arises and therefore future earnings are not decreased by goodwill amortization. Furthermore, shareholders' funds represent the total of both buyer and seller plus, in many countries, would be available for distribution.

Merger accounting is so attractive that, where it is allowed, strict conditions must be met before it can be applied. Such conditions are aimed at ensuring that the substance of the transaction is a merger, or uniting of interests. For example, IAS No. 22 requires use of the purchase method except where shareholders of the combining enterprises achieve a continuing mutual sharing in the risks and benefits attaching to the enterprise. Uniting of interests is further defined as business combinations where -

a) the basis of the transaction is principally an exchange of voting common shares of the enterprises combined (i.e., little or no cash changes hands), and

b) the whole, or effectively the whole, of the net assets and operations of two enterprises are combined in one entity.

As noted above, merger accounting is illegal in Nigeria because the Companies Act, 1968 requires valuation of shares issued at the fair value of consideration received, with any difference versus par value of shares issued treated as share premium. Nigerian companies are thereby forced to apply the purchase method of accounting and to establish goodwill.

Our brief discussion of "Structuring the Deal" has illustrated some of the complexities of merger and acquisitions - particularly as to financial, tax and accounting considerations. Appendix 'A' has been attached to summarize the principal basic transaction alternatives commonly used in global markets for mergers and acquisitions. We have also pointed out some of the constraints or issues involved in Nigerian practice - which leads to the concluding part of today's paper.

MARKET CHARACTERISTICS AND CONSTRAINTS

Development of free markets in securities within Nigeria will depend on resolution of several specific issues as well as removal of certain environmental constraints. Lets deal with constraints first, which may be cultural in nature thereby requiring education, or legal constraints which require changed laws or regulations.

Mergers and acquisitions are rare in Nigeria. There is a bias towards buying and holding assets which carries over into infrequent changes in business ownership. Many proposed transactions fail, even where all parties agree to the economic logic, because of non-financial interests.

Personal interests are important in all countries, but Nigerians place particular emphasis on non-financial factors such as retention of "Director" status or on ethnic, regional or religious grounds. For example, deals between private companies can break down because an increase to more than 50 shareholders requires a public company and therefore shareholders become concerned with inability to control future ownership changes thereby permitting "undesirables" to become shareholders. Board approval of share transfers thereby works to effectively screen shareholders (which serves a desirable purpose) but also prevents free-markets from developing.

The above illustration is perfectly understandable yet helps explain why, despite the exigencies created by SAP, a rational and free securities market may be a lengthy process to develop. Other examples abound and illustrate the constraints involved.

Bonus issues are another instance of an irrational market.

For example, when a company announces a 1 for 1 bonus issue for a share standing in the market at N1.00 per share, the market price normally would drop to about 50 Kobo since, while shares have doubled, the company's underlying market value is unchanged. Such decline does not happen in Nigeria, at least in the short term, since market value hardly alters at all thereby making bonus issues very popular indeed.

A similar feature is the dividend yield required by investors in Nigerian companies. Typically, dividend payments run from 50% to 100%, thereby leaving little capital to fund growth of the business. Particularly in inflationary times, this practice leads to erosion of equity base thus requiring growth to be financed by debt or leading to contraction of business activity. Unfortunately, the use of historical cost contributes to this vicious cycle because of the tendency, during inflationary times, to overstate earnings.

The above market characteristics create an inertia which may take years to overcome as Nigeria moves towards free securities markets. An even larger barrier, which could be removed relatively quickly, is the price setting mechanism itself.

Unlike other countries which let the buyer and seller freely negotiate a transaction price, the Securities and Exchange Commission (SEC) is charged by law with determining the price at which shares can change hands. Such prices are based upon statutory formula which take account of historic earnings capitalized at price earnings (P/E) ratios of between 5 and 7 or net asset values as shown in the accounts. The resulting problem is threefold -

(1) Historic operating performance is not a reliable guide to future profitability and value of a business in today's SAP environment. Performance during licensing, or under SFEM, or now in highly inflationary times is not likely to be similar in the future. Pricing of shares must therefore be based on prospective earnings and cashflow, even though any forecast must be highly subjective given the uncertain political/economic outlook.

(2) Net asset values at historic cost are no measure of the underlying asset values of a business post - SFEM, particularly since pre-SFEM asset purchases will now sell for many multiples of their original book values. Yet SEC guidelines specifically preclude the use of recent asset revaluations in the pricing formulas. Moreover, the SEC formula takes no account of any real goodwill (such as brand values) which attach to a business.

(3) Lastly, the use of a P/E ratio restricted to 5 - 7 times earnings is not logical because one can easily identify industries and companies which should be lower or higher than this range implies.

To be consistent with the objectives of SAP, the SEC price mechanism should be deregulated to allow a free market to develop and to facilitate the much needed increase in merger and acquisition activity. The objective should be to have securities change hands at prices determined by willing buyers and willing sellers. SEC could then focus on its much more important role of making sure the Nigerian capital markets develop to fund future economic growth while still making sure that market mechanisms work properly and the public interest is protected.

Such deregulation would immediately put pressure on Nigeria's accounting, tax and legal structure. The moment shares are priced in excess of book value of assets acquired, the buyer must record goodwill which will not be tax deductible against future earnings unless attributable to fixed assets acquired. At the risk of overlapping with the next paper, there are three further illustrations to mention -

(1) The Nigerian tax law fundamentally does not recognize merger transactions and group tax accounting, or group tax relief. All mergers are therefore structured as acquisition transactions and companies are forced to create divisions rather than subsidiaries. Both practices discourage merger and widespread share ownership.

(2) The Nigerian Enterprises Promotion Board (NEPB) regulates the activities of companies with foreign ownership and require certain foreign/Nigerian ownership ratios depending on industry classification. Such companies have been treated as foreign companies, thereby discouraging merger and acquisition activity generally and investment between NEPB schedules particularly.

(3) Recent Industrial Policy announcements have been designed to attract direct foreign investment, yet the NEPB rules still make merger and acquisitions unattractive to the foreign investor. The new policy applies only to <u>new</u> foreign investors, thereby preventing merger with or acquisition of an existing company.

CONCLUSION

SAP has created the need for rationalization of business interests in Nigeria, particularly for steps aimed at improving economic returns, efficient utilization of existing resources and improved capacity utilization. As a result, there is greatly expanded scope for merger and acquisition activity.

We have reviewed how such transactions should be planned, structured and implemented to be successful. We have also explored the major financing, tax and accounting alternatives involved in structured deals - both globally and here in Nigeria. We have lastly spotlighted several of the key cultural and regulatory obstacles which need to be dealt with in moving towards a viable and free securities market. Five key points merit final emphasis -

(1) Deregulation of SEC pricing role is needed to encourage businesses to merge or change hands at prices mutually agreed between willing sellers and willing buyers.

(2) Investor education is needed to eliminate the cultural impediments and irrational market behaviour which inhibits business combinations.

(3) Tax laws need revision to allow group relief for losses, facilitate share transactions, and provide tax relief on goodwill inherent in the purchase price.

(4) The Company Law requires amendment to facilitate merger accounting for a true pooling (or uniting) of interests where the transaction substance is clearly a merger.

(5) NEPB regulations should be amended to facilitate merger/ acquisition activities and, in light of the new Industrial Policy, attract new foreign investment to both new and existing enterprises.

With Nigeria currently suffering from stagflation and the urgent need for the SAP process to be supplemented by growth producing investment, it is time to move to deregulate capital markets and thereby free up merger/acquisition activities to make their needed contribution to the economy. The above five points highlight the key priorities and the required rules of the game. New practices and experience will develop rapidly thereafter. There is a wealth of international experience to draw on and it can be adapted readily to Nigeria's unique requirements. The process of developing free capital markets generally and active merger/acquisition market specifically will take time. But it is clearly time to start since free capital markets are necessary for renewed growth and merger/acquisitions are just as clearly essential to ensure better utilization of Nigeria's existing resources and productive capacity.

APPENDIX A

FINANCING OF MERGERS AND ACQUISITIONS

The following table summarises the principal basic transaction alternatives commonly used.

		PROS	CONS
1.	Shares	. No cash required . Accounting benefits possible	. Dilution of control . EPS dilution . Dividend cost
2.	Excess cash	. Little cost	. Often insufficient to fund totally . Impact on liquidity
3.	Earn out or Note to seller	. Frequently easier to get than third party debt . Less risky . Keep seller committed	. Keeps seller involved
4.	Borrowing	. Ease and convenience	. Impact on liquidity
(i)	Under Existing Bank Lines	. Low transaction cost	. Risk of bank line reduction . Jeopardize bank relationship . Debt service burden on future cash flow
(ii)	Obtain longterm Third-Party Funding	. Matches assets and liabilities	. Inflexible . Requires amortization . Debt service burden on future cash flow
(iii)	Asset-based package	. Highest leverage permitted . Low cash investment . Cash flexibility	. May carry higher interest costs . Security interest

In practice, most transactions are very complex and often involve a combination of two, three or even four of these methods in a package which best balances the various needs of buyer and seller.