

# **Key to Successful M&A Transaction: An Appraiser's View on Consideration**

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### ***Abstract***

This article begins with the basic descriptions of mergers and acquisitions (M&A). Next it introduces the corporate motives for making an M&A transaction as well as the valuation of firm value as a reference to negotiate the consideration. Then it describes the various forms of consideration followed by a simplified case on an M&A transaction executed by a Hong Kong listed company where consideration has been sharply inflated due to fair value adjustment, resulting in substantial impairment loss. Lastly it discusses possible solutions in post-acquisition valuation of the above case and concludes by suggesting some precautionary actions in setting up the terms of convertible bonds.

### ***Introduction***

Mergers and Acquisitions (M&A) is a common way for a company to expand their business in modern finance. In the recent trend of increasing complexity of corporate actions, it is harder and harder to distinguish between mergers and acquisitions. Typically an acquisition refers to a company buying only part of another company in mainly two forms: asset acquisition and share acquisition. Asset acquisition refers to the purchase of all or some key assets of another company whilst share acquisition refers to the purchase of shares of another company which number of shares is sufficient to obtain the corporate control. A merger occurs when at least one of the targets cease to exist after the transactions. In the following the term "mergers and acquisitions" will be used interchangeably with "mergers" or "acquisitions". The following describes the motives of initiating an M&A transaction as well as forms of consideration. These would make up a reference price (or price range) for buyers and sellers to negotiate for the amount of consideration.

### ***Corporate Motives for M&A***

Typical reasons for mergers and acquisitions include: undervaluation, diversification, operating synergy, financial synergy and control.

- ◆ Undervaluation occurs when a company is priced considerably under its fundamental value in financial markets. A capable acquirer would be interested

to take the opportunity and wait for the value to recover to its true value.

- ◆ Diversification refers to the situation where an acquirer wants to diversify its business risk by investing in a totally different business. It is controversial as shareholders can achieve the same goal but more cheaply by buying unrelated stocks themselves.
- ◆ Synergy refers to the additional value created when the companies operate together instead of operating separately. Synergy can be either operational or financial. Operational synergy generally refers to achieving economies of scale, enhancing growth, increasing market dominance and saving operational costs. Financial synergy generally refers to tax benefits, debt capacities and better investment/project opportunities.
- ◆ Control refers to taking over and restructuring a poorly organized company to create value.

### ***Grounds for Negotiation***

For an acquisition to be completed, buyers and sellers negotiate to form considerations. For M&A due to undervaluation and diversification, the firm value is estimated as if they were stand-alone. For operating synergy, greater revenue, higher growth, lower operating cost can be applied in evaluating the firm value; for financial synergy, tax reduction and lower financing cost could be used; for control, better efficiency and profitability can be taken. As a natural consequence, the total consideration of M&A transactions should not worth more than the firm value after considering the benefits from different synergies and control because otherwise the profitability from M&A transactions is highly questionable. How to set up the considerations is therefore considered as a crucial part of a successful transaction.

### ***Forms of M&A Consideration***

Common constituents of M&A considerations include cash, ordinary shares, straight debt, warrants, preference shares, profit guarantee, buyback/putback clauses and convertible bonds.

- ◆ Cash is the safest and most direct way of payment. In most cases, the consideration would be a mixture of cash and some financial instruments.

- ◆ Ordinary shares are common choices especially when the acquirer's management thinks their shares are over-priced. When the acquirer is lack of capital or needs to refine their capital structure, they would consider issuing straight debts.
- ◆ Warrants could be issued in addition to straight debts for which equity nature is included in the investment making the considerations more attractive to holders.
- ◆ Preference shares entitle holders to receive a special dividend (usually higher) before ordinary share holders receive theirs. Thus, preference shares carry the characteristics of both straight debts and ordinary shares.
- ◆ Profit guarantees and buyback/putback clauses protect buyers/sellers based on the future performance of the target. They are typical examples of contingent considerations which may potentially cause valuation issues. The impact of contingent considerations could be great depending on the actual terms and conditions.
- ◆ Convertible bonds are hybrid instrument that possess the nature of both debt and equity shares. They have a denominated principal amount, in which the principal amount could be converted into ordinary shares of the issuing company during conversion period, and make coupon payments within its life and principal repayment at maturity if no conversion has occurred.

Convertible bonds are one of the most complex forms of financing in M&A. They can involve other derivative features including call and put conditions, further increasing the complexity. When they comes to valuation for reporting and compliance purposes on the date of bond issue, their fair value is often required to match with its principal amount according to arm's length transaction principle. However in a Purchase Price Allocation (PPA)<sup>1</sup> for an M&A transaction, the requirement sometimes cannot be fulfilled and may be even unnecessary. The following will describe a simplified case from a Hong Kong listed company where its issuance of convertible bond in an M&A created a big impact to the corporate reporting profit.

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<sup>1</sup> Purchase price allocation, or PPA, is an application of goodwill accounting whereby one company (the acquirer), when purchasing a second company (the target), allocates the purchase price into various assets and liabilities acquired from the transaction. (from Wikipedia)

### ***Case Study***

In May 20X0, a company entered into an acquisition agreement with considerations including a non-interest bearing convertible bond with principal amount of HK\$1.8 billion that will be issued in May 20X1. The convertible bond will become mature in 5 years from the date of issue which is convertible into ordinary shares of the Company any time during its life at HK\$1.00 which was the market share price at that time. The bond has no other derivative feature except conversion. The transaction was then completed in September 20x0. However, the share price soared to HK\$1.83 in September 20x0 and HK\$1.7 in December (financial period end). The consideration payable inflated to HK\$4.0 billion which created a large goodwill. At year end, the fair value of the operation could not support the unexpected large amount of goodwill. Hence, the company tragically recorded a substantial goodwill impairment loss.

### ***Post-acquisition valuation***

In post-acquisition valuation, there are some ways to lower the fair value of the consideration payable. Examples include dilution effect and conversion limit. Dilution effect refers to the possible decrease in value per share when large quantity of new shares is issued in the future. Believers in market efficiency would argue that the effect would immediately reflected on the day of announcement as the professional investors would know the effect of the transaction and then promptly react on the announcement. As for conversion limit, the Codes on Takeovers and Mergers and Share Repurchases published by the Securities and Futures Commission of Hong Kong requires a mandatory offer when any person or connected parties acquires 30% or more of the voting rights of a company unless a waiver has been applied. Therefore a 30% conversion limit could be applied to the convertible bond valuation. However the inclusion of conversion limit is still controversial in practice especially when the bond is freely transferrable.

### ***Recommendations***

The above suggests post-acquisition saving plans may easily fail. The following discussion will be made from the viewpoint of convertible bond issuers (acquirer in M&A) on their best ways to avoiding such corporate tragedies. Firstly, the most direct way is to make the completion date as close to the date when the terms and conditions are fixed. This is to reduce the chance of unfavorable share price

movement that would increase the consideration. A second way is to make the conversion price to be set on the date of completion with reference to, for example, the average of the closing price of the last 5 trading days before the date of completion. In this way the gap between the market price on the date of completion and the conversion price should be minimal. A third way is make the convertible bond callable at any time during the life of the bond, that is, the issuer has the right to call back all the convertible bond at certain percentage of the principal amount. The issuer is given the right to call back the bond when the share price is adverse to them.

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