ORDINE DEI DOTTORI COMMERCIALISTI E DEGLI ESPERTI CONTABILI
MILANO

FONDAZIONE COMMERCIALISTI ODCEC di MILANO

Le operazioni di M&A: aspetti strategici e operativi

L'innovazione *driver* per la crescita aziendale e le operazioni di M&A

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Agenda

I. Six Waves of Mergers

II. Value Creation in Acquisitions

III. Problems with Acquisitions

IV. Mini-Case: the Luxottica – Essilor Merger

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Section I

Six Waves of Mergers

Six Waves of Mergers

- Most historians believe that there have been six **waves** of mergers, the first four occurring mainly in the Unites States.
- According to some experts we might see now the start of a seventh wave.
- Although each wave is a product of its own circumstances, they typically arise in strong **bull markets** and fade when the market declines broadly.

First Wave
"Merging for monopoly" (1893 - 1907)

- During this wave, there were major horisontal mergers in the basic manufacturing and transportation industries.
- This wave was dominated by large steel and railroad mergers that led to a number of enormous trust monopolies, controlled by the likes of J.P.Morgan, John D. Rockefeller and Andrew Carnegie (also known as "the robber barons").
- The monopolies created in the first merger wave were possible because companies were not constrained by government regulation.

Second Wave
"Merging for oligopoly" (1919 - 1929)

- After World War I, consolidation in the industries that were the subject of the first wave continued, and more.
- As monopolies and oligopolies tried to grow even after they dominated their industries, vertical integration became more common.
- General Motors, the largest US company, got its start during the second wave.
- The wave ended with the market crash in 1929 and the Great Depression that followed.

Third Wave
"Conglomerate mergers" (1945 - 1973)

- During this wave numerous established us companies embraced the diversified conglomerate paradigm, and new conglomerates (like ITT) were built from the ground.
- Under the leadership of Harold Geneen, International Telephone and Telegraphs (ITT) merged with nearly 250 companies in the span of a decade, many of them in unrelated businesses.
- The merger wave gradually ended in the early 1970s as the Dow Jones fell by more than a third and a worldwide energy crisis began, leading to a devaluation of the US dollar.

Fourth Wave
"Hostile takeovers" (1980s)

- During the 1980s the number of hostile takeovers proliferated, and they were recognised gradually as an acceptable tool for growing companies.
- Corporate raiders - such as Carl Icahn, T. Boone Pickens and Ronald Perelman - profited handsomely by putting companies into play.
- In addition to hostile takeovers, junk bond financing (invented by investment bank Drexel Burnham Lambert) and leveraged buyouts became commonplace.
- The wave ended amid the collapse of the junk bond market, the implosion of Drexel Burnham, and the serious loan portfolio and capital problems faced by commercial banks in the US.

Fifth Wave
"Cross-border mergers" (1993-2000)

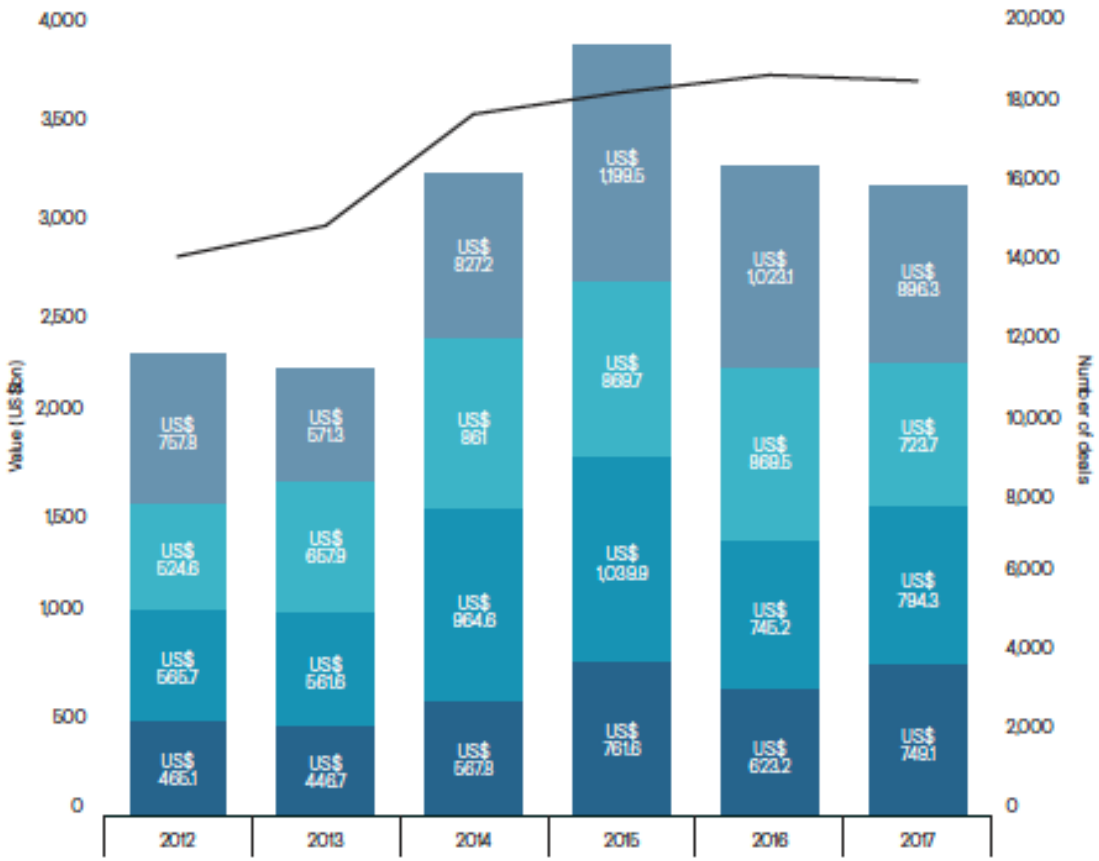
- This wave appears to be an international one, as many of the most notable mergers have been either entirely outside the United States or have involved a non-US party.
- More mergers and acquisitions are cross-border transactions as real growth for many companies can only be accomplished on a global scale.
- There has been a worldwide consolidation in many industries, such as: the automobile, telecommunications, airlines, and metal industries.
- In the highly regulated industries, such as banking, the merger activity is mostly domestic, but even this domestic consolidation is often a response to international competition.

Sixth Wave
"Private Equity" (2003-2007)

- This wave was driven mainly by the availability of cheap money and the mispricing of risk.
- Private equity funds took the lead and closed an impressive number of leverage buyouts (LBOs). Secondary buyouts (SBOs) became very popular with a PE fund buying a firm from another PE fund.
- The wave ended with the subprime crisis and the ensuing credit crunch. As a consequence a significant number of these deals has to be restructured or unwound, while many others are still in the portfolios of the funds, waiting for an exit in better market conditions.

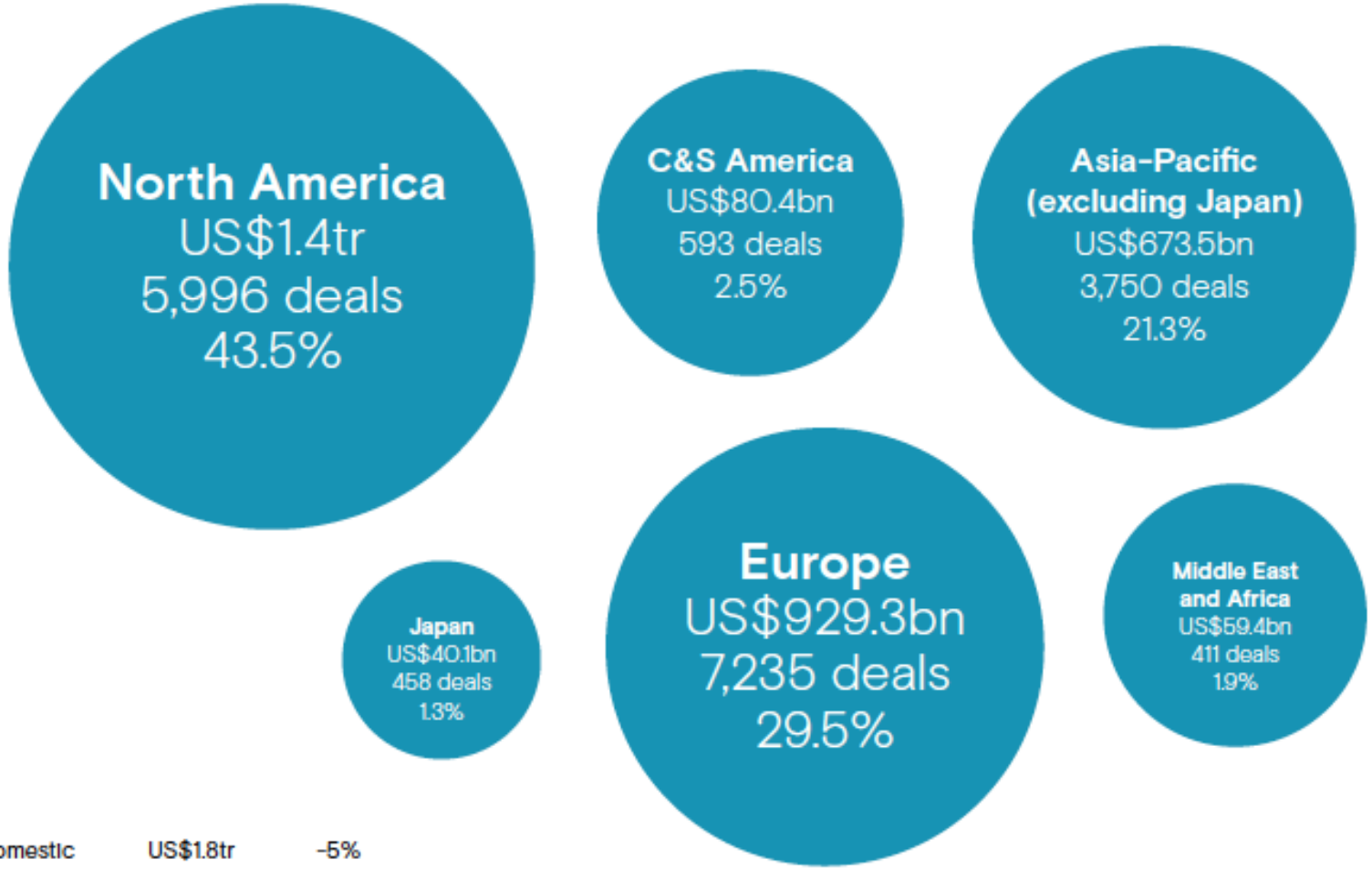
Recent Developments

Global M&A Annual Trend



Source: **www.mergermarket.com**

Global M&A Geographic Breakdown (Jan - Dec 2017) by Value



Domestic	US$1.8tr	-5%
Cross-border	US$1.3tr	-0.1%

Private IPOs

"The easy availability of investor cash has allowed many technology companies to delay listing on public markets but caused a surge in trading of a different kind: in the private shares of unlisted companies. For US venture-backed tech companies, the private market has outstripped the public market when it comes to raising capital this year. So far they have raised just $600 million through initial public offerings, and 35 times as much — or $20 billion — through private offerings, also known as "private IPOs"… This boom in private primary offerings has translated into demand for secondary trading platforms from companies, their employees and investors… Much of the increase is due to the fact that more tech companies today have crossed the $1 billion threshold, a status that used to be so rare that the companies are known as 'unicorns'."

Leslie Hooks, FT – 3rd June, 2015

Tech Start-ups stay private

"Tech start-ups are waiting "way too long to go public", the head of Google's venture capital arm has warned, highlighting a widening rift in Silicon Valley over the fate of the latest generation of fast-growing start-ups. Many of the companies leading the current technology boom, including Uber and Airbnb, have sought to stay private as long as possible and have raised ever-larger amounts of money from successive rounds of private investment. But the mood is changing and investors are growing skittish. Some start-ups may rue their decision exploit the booming private markets to push for high headline valuations, rather than selling shares to the public, said Bill Maris, head of Google Ventures, one of California's most active VC firms… Next year, many will be unable to raise more cash in the private markets or be forced to accept lower valuations, he predicted."

Richard Waters, FT – 7th December, 2015

The Billion Dollar Start-up Club (January 2018)

Source: WSJ

Didi Chuxing valued at $50 billion

"Didi Chuxing is poised to raise $5 billion - $6 billion from investors… an infusion of cash that China's ride-hailing group will use to expand its transportation services beyond the country's borders. The investment will value the company at $50 billion, including the new funds raised, which makes Didi the world's second most valuable private tech start-up after Uber. The deal will mark an acceleration of the fundraising bonanza in the ride-hailing tech sector, which has set records for funds raised… As China's biggest ride-hailing company, Didi has already raised more than $10 billion in debt and equity in previous fundraising rounds, from investors as varied as Apple, Foxconn and Alibaba. The valuation that investors assign to the company has accelerated rapidly, from $25 billion last June, to $34 billion last autumn, and now $50 billion. Investors in the latest round include tech fund Silver Lake Kraftwerk, Japanese tech group SoftBank and China Merchants Bank… Didi will use the funds for international investments, as well as work on self-driving cars and artificial intelligence… While Didi only operates in China at present, it has made investments in San Francisco-based Lyft, Grab in Southeast Asia and Ola in India."

Leslie Hook, FT – 27th April, 2017

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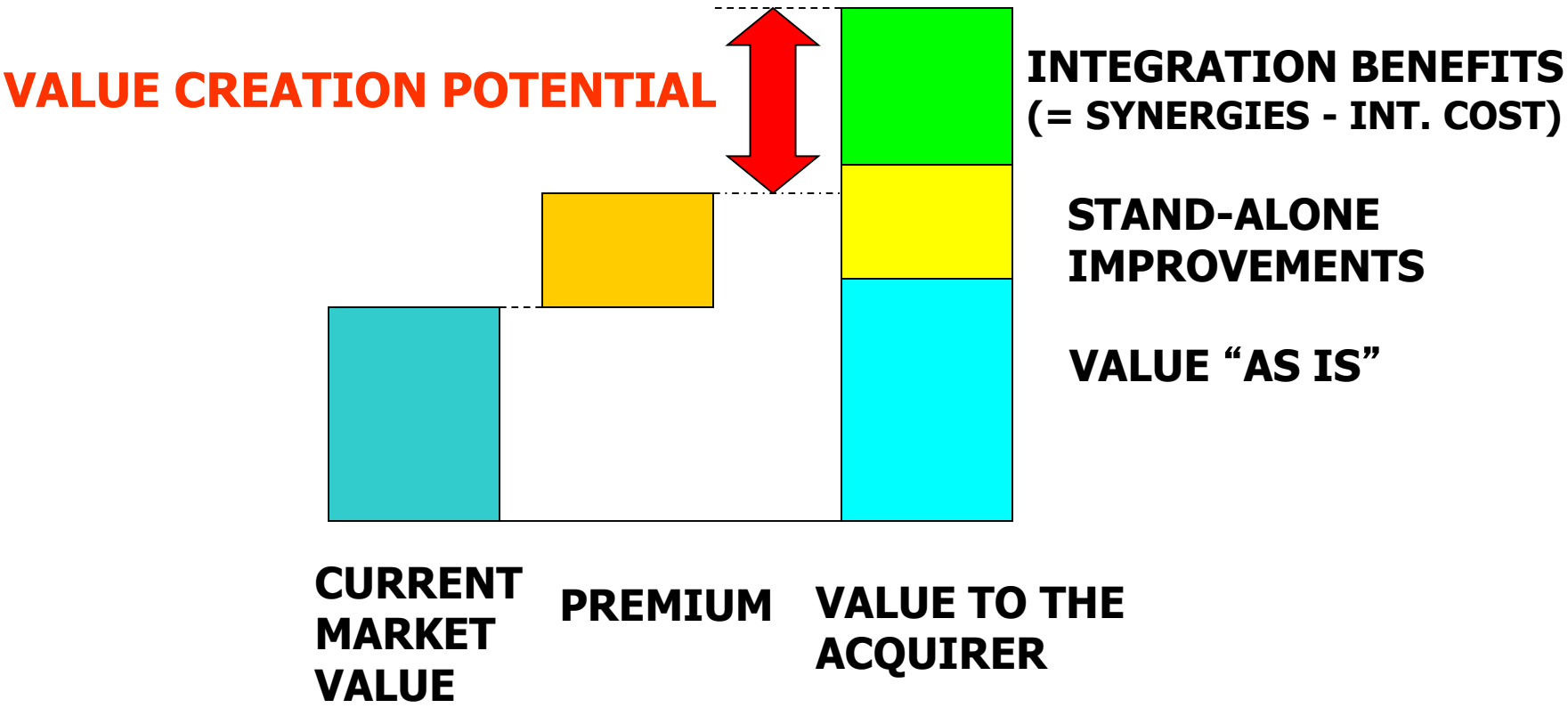
Section II

Value Creation in Acquisitions

Value Creation in Acqusitions

- Companies engage in M&A activity with the objective of creating value for their shareholders.
- The value can be generated through **stand-alone improvements** and **synergies**.
- However the majority of acquisitions fail to create value, and many of them destroy shareholder value.

Value Creation Potential



Main Types of Synergies (1/2)

- **Cost Saving**: this is the most common type of synergy and the easiest to estimate, and they are also labelled as ***"hard synergies"***. They often come from eliminating jobs, facilities, and related expenses that are no longer needed when functions are consolidated, or they come from economies of scale in purchasing.
- **Revenue Enhancements:** it is sometimes possible for an Acquirer and its Target to achieve a higher level of sales growth together than either company could do on its own. In fact, sometimes the Target brings a superior or complementary product to the more extensive distribution channel of the Acquirer. In other instances, a Target's distribution channel can be used to escalate the sales of the Acquirer's product. Revenue enhancements are notoriously hard to estimate and they are often described as ***"soft synergies"***.

Main Types of Synergies (2/2)

- **Process Improvements**: they occur when managers transfer best practices and core competencies from one company to the other. That results in both cost savings and revenue enhancements. The transfer of best practices can flow in either direction.
- **Financial Engineering**: an example is when a transaction allows the Acquirer to refinance the Target's debt at the Acquirer's more favourable borrowing rate, without negatively affecting the Acquirer's credit rating.

Synergies play a role in: Valuation, Negotiation, Integration

- The synergies between the Acquirer and the Target are specific to each Acquirer. The value of synergies is normally «split» between the two as part of the price ***negotiation***.
- The quantification of synergies is part of the ***valuation*** process.
- Synergies can materialise only through a successful ***integration***.

Sources of Synergies

Cost reduction ("hard" synergies)

Variable

- Purchasing scale
- Labor productivity
- Manufacturing efficiency benefits
- Consumer and trade spending efficiencies
- Transportation

Fixed

- Manufacturing
- Sales & Marketing
- Distribution
- G&A

Revenue enhancement ("soft" synergies)

- Product cross-selling
- Channel distribution enhancement
- Portfolio strengthening
- Geographic expansion
- New business development

Negative synergies

- Loss of customers/ revenues
- Loss of key employees
- Competitors take action

Integration costs

- Costs such as severance, plant shut-downs, relocations, etc.
- Typically non-recurring (one-time)

Analysis of Value Drivers

- Headquarters/ overhead sharing

Procurement*

IT, Finance, Legal

HR Management

R&D

Inbound Logistics	Operations	Outbound Logistics	Marketing & Sales	Service
• Raw materials purchasing consolidation *	• Manufacturing plants rationalization • Process reengineering	• Distribution consolidation	• Media purchasing consolidation • Salesforce efficiency • Channel efficiency	• After-sale service consolidation

The Drive for Mergers and Acqusitions

Growth is the lifeblood of business, creating cost efficiencies and pricing power, while opening up new markets and fresh opportunities. Typically, growth is generated in one of three ways: organically, on the rising tide of an expanding industry or through acquisition... Yet while the drive to acquire is about fuelling top-line growth with additional sales of products and services, bottom-line profitability does not always follow… Faced with the prospect of stagnant growth, companies find it hard to resist the lure of acquiring growth elsewhere.

Geraldine Lambe, FT, 26th May 2011

Italian Lesson on Whether to Bid

The Hershey Trust Company is pressing ahead with plans for a Cadbury counter-bid. Let's hope it first listened to Michele Ferrero, big daddy of the family owned Italian confectioner. In deciding not to pursue the UK group, he has given an object lesson in the risks inherent in ambitious dealmaking.

In practice, all would-be acquisitors should cut out and keep Mr Ferrero's reasons for not bidding against Kraft:

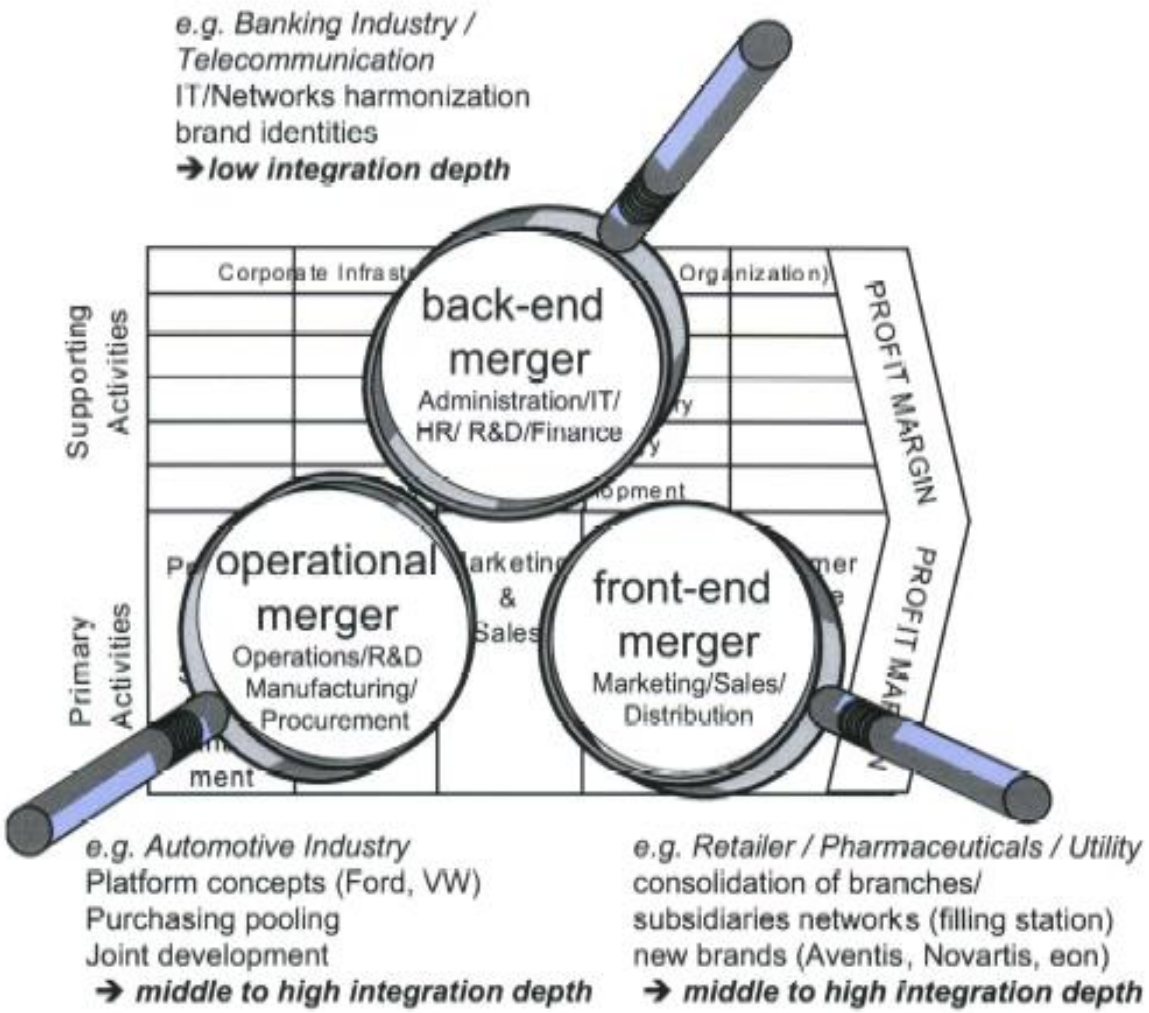
1. *Too disruptive…*
2. *Too much debt….*
3. *Too little added value…*
4. *Too controversial…*

…if you're a listed company executive, the next time advisers tout a transformational takeover, you should unwrap a Ferrero Mon Chéri, let it melt in the mouth and, before deciding, answer one question: ***che cosa farebbe Michele?*** What *would Michele do?*

Andrew Hill and Louise Lucas, FT, 13th January 2010

Typology of Generic Post-Merger Integration Approaches

Source:
R. Meyer,
M. G. Rukstad,
P. J. Coughlan,
S. A. Jansen (2002)



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Section III

Problems with Acquisitions

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Acquisitions

- **Integration difficulties**
- **Inadequate evaluation of Target**
- **Large or extraordinary debt**
- **Inability to achieve synergies**
- **Resulting firm is too large**
- **Managers overly focused on acquisitions**
- **Too much diversification**

Problems With Acquisitions: 1. Integration Difficulties

- Integration challenges include:
  - melding two disparate corporate cultures;
  - linking different financial and control systems;
  - building effective working relationships (particularly when management styles differ);
  - resolving problems regarding the status of the newly acquired firm's executives;
  - loss of key personnel weakens the acquired firm's capabilities and reduces its value.

Problems With Acquisitions: 2. Inadequate Evaluation of Target

- Evaluation requires that hundreds of issues be closely examined, including:
  - financing for the intended transaction;
  - differences in cultures between the acquiring and target firm;
  - tax consequences of the transaction;
  - actions that would be necessary to successfully meld the two workforces.
- Ineffective due-diligence process may result in paying excessive premium for the target company.

Problems With Acquisitions: 3. Large or Extraordinary Debt

- Firm may take on significant debt to acquire a company.
- High debt can:
  - increase the likelihood of bankruptcy;
  - lead to a downgrade in the firm's credit rating;
  - preclude needed investment in activities that contribute to the firm's long-term success.

Problems With Acquisitions: 4. Inability to Achieve Synergies

- Synergies exist when assets are worth more when used in conjunction with each other than when they are used separately.
- Firms experience transaction costs (e.g., legal fees) when they use acquisition strategies to create synergies.
- Firms tend to underestimate indirect costs of integration when evaluating a potential acquisition.

Problems With Acquisitions: 5. Too Much Diversification

- Diversified firms must process more information of greater diversity.
- Scope created by diversification may cause managers to rely too much on financial rather than strategic controls to evaluate business units' performances.
- Acquisitions may become substitutes for innovation.

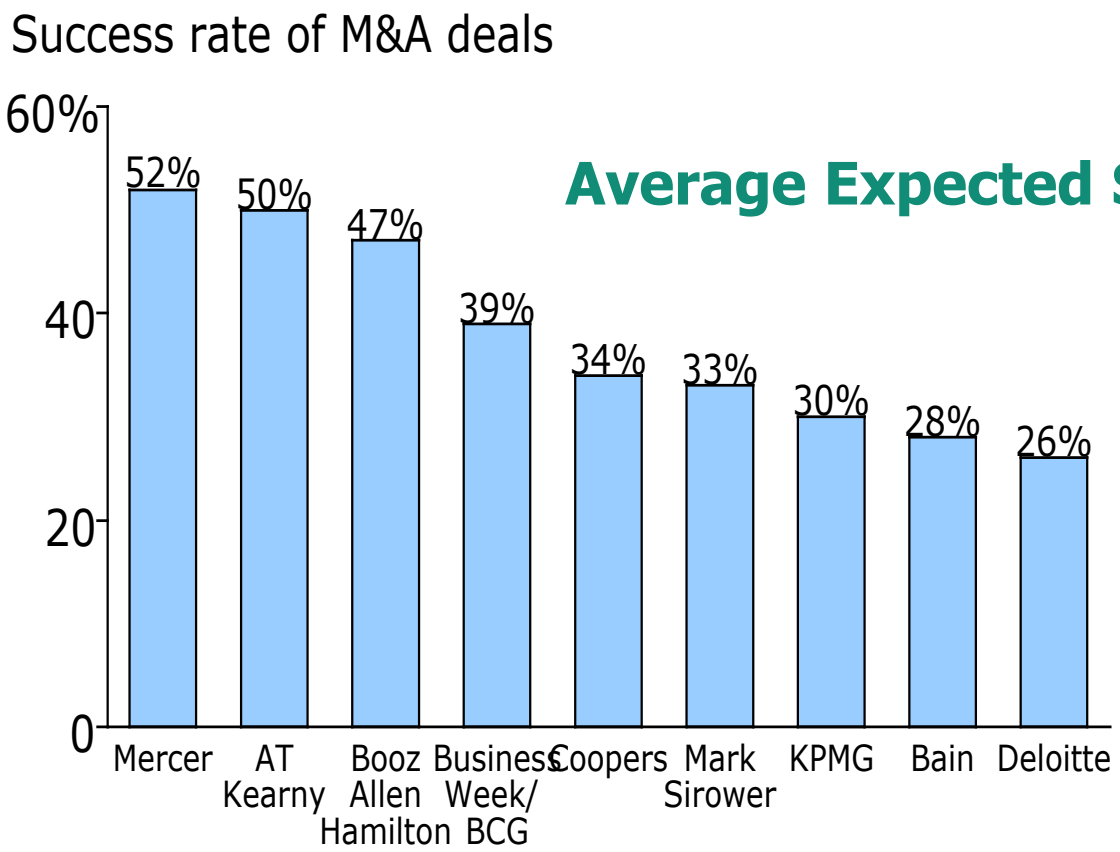
Problems With Acquisitions:
6. Managers Overly Focused on Acquisitions

- Managers in Target firms may operate in a state of virtual suspended animation during an acquisition.
- Executives may become hesitant to make decisions with long-term consequences until negotiations have been completed.
- Acquisition process can create a short-term perspective and a greater aversion to risk among top-level executives in a Target firm.

Problems With Acquisitions: 7. Too Large

- Additional costs may exceed the benefits of the economies of scale and additional market power.
- Larger size may lead to more bureaucratic controls.
- Formalized controls often lead to relatively rigid and standardized managerial behavior.
- Firm may produce less innovation.

Historic Success Rate



Average Expected Success Rate: 37%

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Section IV

Mini-Case: The Luxottica-Essilor Merger

Source: BSIC – Bocconi Students Investment Club

The Companies

Luxottica Group S.p.A. (BIT: LUX) — market cap as of 16/02/2018: € 24.58 billion

Essilor International SA (EPA: EI) — market cap as of 16/02/2018: € 23.81 billion

The Announcement

- On January 16, 2017, Italy-based eyewear leader Luxottica SpA and French lensmaker Essilor International SA announced one of the largest cross-border mergers ever in Europe. The combined company, which should have an estimated market value of about €47bn (pre-synergies), will be a global leader in the €90bn fast-growing eyewear industry.

Luxottica

- Luxottica is the world's largest eyewear company. Founded in 1961 by Leonardo Del Vecchio, who to this date is Executive Chairman, it is headquartered in Milan, Italy and over the years has expanded its presence to more than 150 countries across 5 continents. The company is currently listed in Milan and New York.
- As a vertically integrated business, the company designs, manufactures, distributes and retails its products. Its portfolio includes both proprietary brands, among which Ray-Ban, Persol and Oakley, as well as licensed brands, including Giorgio Armani, Bulgari and Valentino.

Essilor

- Essilor is a French company founded in 1849 and listed in the Euronext Paris. The group's historical activity has been producing corrective (ophthalmic) lenses of which it is, as of today, the world's largest manufacturer. More recently, it is has also expanded its operations in the sun and reading glasses businesses as well as in the production of ophthalmic instruments and equipment.
- With as many as 250 acquisitions completed in 10 years, the company has been growing quickly, and profitability has been consistently improving. Essilor had been included in Forbes' ranking of the World's 100 most innovative companies.

The Deal Rationale

- The deal is backed by a strong rationale. First, the two companies have highly complementary business models: Luxottica focuses on the production of sunglasses and frames, whereas Essilor concentrates on lenses manufacturing. Secondly, in recent years both companies have entered lines of business where they faced competition from each other. As a result, and naturally, the merger alleviates the burden of such competition.
- As regards synergies, the companies expect benefits from cost cutting, cross selling and distribution enhancement in the range of €400 million to €600 million per year, of which €200-300 million per annum coming from market growth acceleration (revenue), and €200-300 million per annum from supply chain optimization as well as G&A and purchasing cost reduction (cost).

Current Status

- Italian eyewear maker Luxottica (LUX.MI) and French lens manufacturer Essilor (ESSI.PA) are set to win unconditional EU antitrust approval for their 48 billion-euro merger.
- Having had some initial concerns about the deal between Luxottica, the world's biggest eyeglass frame maker and Essilor, the biggest lens maker, the European Commission is scheduled to decide by March 8, 2018 on whether to clear it.
- The deal has already secured the regulatory green light in Australia, Canada, Colombia, India, Japan, Morocco, New Zealand, Russia, South Africa, South Korea and Taiwan. U.S regulators are also expected to give the go-ahead. However, the authorities in Singapore and Brazil aretaking a closer look.

Source: Reuters – December 14, 2017