

LECTURE 10 | Chapter 20: External Growth through Merger
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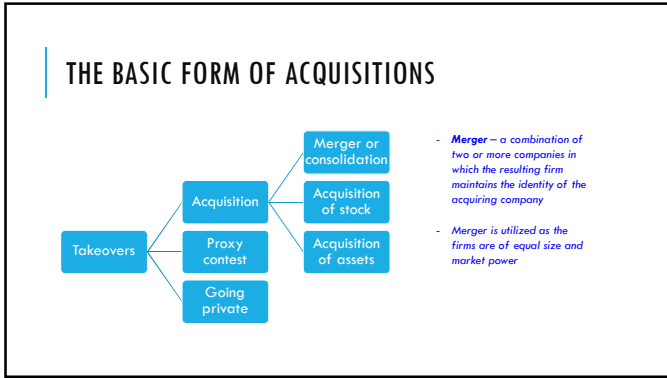
INTRODUCTION

<https://www.youtube.com/watch?v=2bJ9qs5g6oU>

EXTERNAL GROWTH THROUGH MERGER

Main Contents:

1. Basic forms of acquisition
2. Motives for mergers
3. Two "bad" reasons for merger
4. Potential risk for merger
5. Case study



MOTIVES FOR BUSINESS COMBINATION

1. Revenue Enhancement

A combined firm may generate greater revenue than two separate firms. It comes from:

 - Marketing gains
 - Strategic benefits
 - Market or monopoly power
2. Cost reduction
 - Economy of scale: average cost of production falls as the level of production increases.
 - Economies of vertical integration
 - Technology transfer
 - Complementary resources
 - Elimination of inefficient management

MOTIVES FOR BUSINESS COMBINATION

3. Tax gains
 - Net operating losses
 - Debt capacity
 - Surplus funds
4. Reduced capital requirements

TWO "BAD" REASONS FOR MERGERS

1. Earning growth
2. Diversification

<https://www.youtube.com/watch?v=9dFvhq2sKfM>

POTENTIAL RISK FOR MERGER

- Integration difficulties: Culture, financial and control systems, working relationships
- Inadequate evaluation of target,
- Paying excessive premium for target company
- Large or extraordinary debt, Increases the likelihood of bankruptcy,
- Can lead to a downgrade in a firm's credit rating
- Inability to achieve synergy
- Too much diversification
- Managers overly focused on acquisitions

CASE STUDY

You are the chief financial officer of Fly4000 a large company in the airline and travel business whose principal market base is in Europe and the Middle East. Its principal hub is a major Northern European airport and Fly4000 has a small holiday business through its partnership with a number of independent tour operators. It has a good reputation as a business carrier within its European market, earned through very high standards of punctuality and service. Following the recent divestment of associated interests and a joint venture, it has cash reserves of \$860 million.

FliHi is a smaller airline which also has its centre of operations at the same airport as Fly4000. It has, since it was founded in 1988, developed a strong transatlantic business as well as a substantial position in the long and medium haul holiday markets.

You are considering purchasing FliHi. Your analysts project that the merger will result in incremental net cash flows of \$2 million in Year 1, \$4 million in Year 2, \$5 million in Year 3, and \$10 million in Year 4. In addition, the Year 4 cash flow also includes a terminal value of \$107 million.

Assume all cash flows occur at the end of the year. The acquisition would be made immediately, if it is undertaken. FliHi's post-merger beta is estimated to be 2.0, and its post-merger tax rate would be 34 percent. The risk-free rate is 8 percent, and the market risk premium is 4 percent.

- Question: 1. What is the value of FliHi to your company?**
2. Potential values that would be created if the merger happens
 3. Potential risk of the merger

THANK YOU
