Stiles Financial Services, Inc

Monthly Newsletter

Stiles Financial Services, Inc
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Mergers & Acquisitions: What's in the Deal for Investors?

Merger and acquisition (M&A) activity in North America and Europe reached its second highest level on record in 2018. There were 19,501 deals worth $3.6 trillion — a 6.3% increase in deal volume over 2017. There was also a rise in mega deals exceeding $10 billion.[1]

Collectively, U.S. corporations had plenty of cash to spend after a long string of solid profits and a significant tax cut.[2] High stock prices also provided plenty of equity for deals involving the exchange of stock, while relatively-low borrowing costs made it possible to finance acquisitions.

The primary goal of a merger or an acquisition is to boost earnings growth by expanding operations, gaining market share, or becoming more efficient. Here's a closer look at these important transactions and some possible implications for investors.

Deal-making terms

An acquisition is the purchase of one company by another that is paid for with stock, cash, or both. The target firm is absorbed by the buyer, and the buyer's stock continues to trade. The target firm's shareholders may receive stock in the buying company and/or have the option to sell their shares at a set price.

A true merger occurs when two companies of roughly equal size combine into one and issue new stock. In this case, stockholders of both companies generally receive shares in the new company. Some transactions that are technically acquisitions are announced as mergers when the deals are friendly, with both sides agreeing to fair terms. When one company purchases a controlling interest in another against the wishes of the target, it's known as a hostile takeover; these transactions are typically announced as acquisitions.

Benefits and opportunities

Synergy is the financial benefit that is expected from the joining of two companies. This might be achieved by increasing revenue, gaining access to talent or technology, or cutting costs.

Bigger corporations typically benefit from economies of scale, which enables them to negotiate lower prices for larger orders with suppliers. In addition, combining two workforces into one often results in headcount reductions. Some mergers result in industry consolidation, but government regulators may scrutinize deals and/or block mergers that threaten competition. In other cases, companies may join forces across industries for strategic reasons or to diversify their lines of business. Disruptive competition from technology giants is one reason companies have been pursuing large mergers and novel cross-sector acquisitions.[3]

For better or worse

A successful merger should create shareholder value greater than the combined value of the separate companies. To accomplish this, the buyer must have an accurate assessment of how much the target company is worth.

When a deal is first announced, the share prices of both companies are likely to move up or down based solely on investor expectations. Of course, even a well-received merger could eventually be viewed as a disappointment if the merger fails to create enough value.

When a company pays more than the value of the other company's assets, the difference is recorded as "goodwill" so that assets match up with liabilities. Sooner or later, underperforming companies may have to take a write-down in that goodwill value, causing the company's share price to be discounted. Thus, only time will tell whether any particular deal will pay off in the form of future earnings growth or investor returns.

The return and principal value of stocks fluctuate with changes in market conditions. Shares, when sold, may be worth more or less than their original cost. Investments offering the potential for higher rates of return also involve higher risk.

1 PitchBook Data, 2019

2 U.S. Bureau of Economic Analysis, 2018

3 *The New York Times*, May 3, 2018

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