

Chapter 32 Mergers

Multiple Choice Questions

1. Market for corporate control includes the following:

- (I) Mergers
 - (II) Spin-offs and divestitures
 - (III) Leveraged buyouts (LBOs)
 - (IV) Privatizations
- A) I only
 - B) I and II only
 - C) I, II, and III only
 - D) I, II, III, and IV

Answer: D Type: Medium Page: 871

2. The merger of J.P. Morgan and Bank One is an example of:

- (I) Cross-border merger
 - (II) Horizontal merger
 - (III) Conglomerate merger
 - (IV) Vertical merger
- A) I only
 - B) II only
 - C) III only
 - D) I and III only

Answer: B Type: Easy Page: 871

3. Pfizer's acquisition of Pharmacia is an example of:

- (I) Horizontal merger
 - (II) Vertical merger
 - (III) Conglomerate merger
- A) I only
 - B) II only
 - C) III only
 - D) None of the given ones

Answer: A Type: Easy Page: 871

4. AOL's (America Online) acquisition of Time Warner is an example of:

- (I) Cross-border merger
 - (II) Horizontal merger
 - (III) Conglomerate merger
 - (IV) Vertical merger
- A) I and II only
 - B) I and III only
 - C) III only
 - D) IV only

Answer: D Type: Easy Page: 871

5. Daimler-Benz's acquisition of Chrysler is an example of:

- (I) Horizontal merger
 - (II) Conglomerate merger
 - (III) Cross-border merger
 - (IV) Vertical merger
- A) I only
 - B) II only
 - C) I and III only
 - D) IV only

Answer: C Type: Easy Page: 871

6. Walt Disney's acquisition of ABC television network is an example of:

- (I) Horizontal merger
 - (II) Vertical merger
 - (III) Conglomerate merger
 - (IV) Cross-border merger
- A) I only
 - B) II only
 - C) III only
 - D) I and IV only

Answer: B Type: Easy Page: 871

7. The BP and Amoco merger is an example of:

- (I) Cross-border merger
 - (II) Horizontal merger
 - (III) Economies of scale
- A) I only
 - B) I and II only
 - C) I, II, and III only
 - D) III only

Answer: C Type: Medium Page: 871

8. AT&T's acquisition of TCI is an example of:

- (I) Horizontal merger
 - (II) Vertical merger
 - (III) Conglomerate merger
 - (IV) Cross-border merger
- A) I only
 - B) II only
 - C) III only
 - D) III and IV only

Answer: B Type: Easy Page: 871

9. The following reasons are good motives for mergers except:

- (I) Economies of scale
 - (II) Complementary resources
 - (III) Diversification
 - (IV) Eliminating Inefficiencies
- A) I only
 - B) II only
 - C) III only
 - D) I, II, and IV only

Answer: C Type: Medium Page: 873

10. The following are good reasons for mergers:

- (I) Surplus funds
 - (II) Eliminating inefficiencies
 - (III) Complementary resources
 - (IV) Increasing earnings per share (EPS)
- A) I only
 - B) I and II only
 - C) I, II, and III only
 - D) IV only

Answer: C Type: Medium Page: 873

11. The following are good reasons for mergers:

- (I) Economies of scale
 - (II) Economies of vertical integration
 - (III) Complementary resources
 - (IV) Surplus funds
 - (V) Eliminating inefficiencies
 - (VI) Industry consolidation
- A) I only
 - B) I, II, and III only
 - C) I, III, IV, and V only
 - D) I, II, III, IV, V, and VI

Answer: D Type: Difficult Page: 876

12. The following are dubious reasons for mergers:

- (I) to diversify
 - (II) increasing the earnings per share (EPS)
 - (III) lower financing costs
 - (IV) industry consolidation
- A) I only
 - B) II and IV only
 - C) III and IV only
 - D) I, II, and III only

Answer: D Type: Medium Page: 877

13. Firm A has a value of \$100 million, and B has a value of \$70 million. Merging the two would allow a cost savings with a present value of \$20 million. Firm A purchases B for \$75 million. What is the gain from this merger?

- A) \$30 million
- B) \$20 million
- C) \$15 million
- D) \$75 million

Answer: B Type: Medium Page: 881

14. Firm A has a value of \$100 million, and B has a value of \$70 million. Merging the two would allow a cost savings with a present value of \$20 million. Firm A purchases B for \$75 million. What is the cost of this merger?

- A) \$30 million
- B) \$20 million
- C) \$5 million
- D) \$10 million

Answer: C Type: Medium Page: 881

Response: Cost = 75 - 70 = 5

15. Firm A has a value of \$100 million, and B has a value of \$70 million. Merging the two would allow a cost savings with a present value of \$20 million. Firm A purchases B for \$75 million. How much do firm A's shareholders gain from this merger?

- A) \$30 million
- B) \$20 million
- C) \$15 million
- D) \$5 million

Answer: C Type: Medium Page: 881

Response: NPV = 20 - 5 = 15

16. Firm A has a value of \$200 million, and B has a value of \$120 million. Merging the two would allow a cost savings with a present value of \$30 million. Firm A purchases B for \$130 million. What is the gain from this merger?

- A) \$30 million
- B) \$20 million
- C) \$100 million
- D) \$80 million

Answer: A Type: Medium Page: 881

17. Firm A has a value of \$200 million, and B has a value of \$120 million. Merging the two would allow a cost savings with a present value of \$30 million. Firm A purchases B for \$130 million. What is the cost of this merger?

- A) \$30 million
- B) \$20 million
- C) \$15 million
- D) \$10 million

Answer: D Type: Medium Page: 881

Response: Cost = 130-120 = 10

18. Firm A has a value of \$200 million, and B has a value of \$120 million. Merging the two would allow a cost savings with a present value of \$30 million. Firm A purchases B for \$130 million. How much do firm A's shareholders gain from this merger?

- A) \$30 million
- B) \$20 million
- C) \$15 million
- D) \$10 million

Answer: B Type: Medium Page: 881

Response: NPV = 30-10 = 20

Use the following to answer questions 19-20:

Companies A and B are valued as follows:

	A	B
# of shares	2000	1000
Earnings per share	\$ 10	\$ 10
Share price	\$100	\$ 50

19. Company A now acquires B by offering one (new) share of A for every two shares of B (that is, after the merger, there are 2500 shares of A outstanding). If investors are aware that there are no economic gains from the merger, what is the price-earnings ratio of A's stock after the merger?

- A) 7.5
- B) 8.3
- C) 10.0
- D) 5.0

Answer: B Type: Difficult Page: 883

Response: After merger: $EPS = [(2000)(10) + (1000)(10)]/2500 = 12$;

Price = $[(2000)(10) + (1000)(50)]/2500 = 100$; P/E ratio = 8.3

20. Suppose that the merger really does increase the value of the combined firms by \$20,000 (i.e., $PV_{AB} - PV_A - PV_B = \$20,000$). What is the cost of the merger?

- A) Zero
- B) \$2,000
- C) \$8,000
- D) \$4,000

Answer: D Type: Difficult Page: 883

Response: $PV_{AB} = 200,000 + 50,000 + 20,000 = 270,000$; Price per share = $270,000/2,500 = 108$;

Cost = $(108)(500) - 50,000 = 4,000$

Use the following to answer questions 21-25:

The following data on a merger is given:

	Firm A	Firm B	Firm AB
Price per share	\$100	\$10	
Total earnings	\$500	\$300	
Shares outstanding	100	40	
Total value	\$10,000	\$400	\$11,000

21. Firm A has proposed to acquire Firm B at a price of \$20 per share for Firm B's stock. Calculate the gain from the merger.

- A) \$600
- B) \$150
- C) \$550
- D) \$700

Answer: A Type: Difficult Page: 884

Response: $11,000 - 10,000 - 400 = 600$

22. Calculate the NPV of the merger.

- A) \$200
- B) \$400
- C) \$600
- D) \$150

Answer: A Type: Difficult Page: 884

Response: $NPV = \text{Gain} - \text{cost}; (11000 - 10400) - ((20)(40) - 400) = 200$

23. What will be the post-merger price per share for Firm A's stock if Firm A pays in cash?

- A) \$108
- B) \$110
- C) \$102
- D) \$114
- E) None of the above

Answer: C Type: Difficult Page: 884

Response: $P = (10,000 + 200)/100 = 102$

24. Calculate the post merger P/E ratio assuming cash is used in the acquisition.

- A) 12.75
- B) 6.25
- C) 13.75
- D) None of the above

Answer: A Type: Difficult Page: 884

Response: $P/E \text{ ratio} = 102/8 = 12.75$

25. What will earnings per share be for Firm A after the merger assuming that cash is used in the acquisition?

- A) \$6
- B) \$7
- C) \$8
- D) \$5

Answer: C Type: Difficult Page: 884

Response: $EPS = (500+300)/100 = \$8.00$

26. Firm A is planning to acquire Firm B. If Firm A prefers to make a cash offer for the merger it indicates that:

- A) Firm A's managers are optimistic about the post merger value of A
- B) Firm A's managers are pessimistic about the post merger value of A
- C) Firm A's managers are neutral about the post merger value of A
- D) None of the above

Answer: A Type: Difficult Page: 884

27. If firms A is acquiring firm B and Bs shareholders are given the fraction x of the combined firm, then the cost of this merger is:

- A) $\text{Cost} = (x)(PV_{AB}) - PV_B$
- B) $\text{Cost} = PV_{AB} - (x) PV_B$
- C) $\text{Cost} = PV_{AB} - (x) PV_A$
- D) $\text{Cost} = (x)PV_{AB} - (x) PV_B$

Answer: A Type: Difficult Page: 885

28. Which of the following is not a major item of US antitrust legislation?

- (I) Garn-St. Germain Act
- (II) Clayton Act
- (III) Hart-Scott-Rodino Act

- A) I only
- B) II only
- C) III only
- D) II and III only

Answer: A Type: Medium Page: 886

29. The acquisition of stock has the advantage of:

- A) No shareholder meeting to vote is necessary
- B) Minority shareholders may exist
- C) Opening the bidding to others
- D) All of the above
- E) None of the above

Answer: A Type: Medium Page: 886

30. The following mergers have been blocked on antitrust grounds except:

- A) Reynolds and Alcoa
- B) Kroger and WinnDixie
- C) Office Depot and Staples
- D) AOL and Time Warner

Answer: D Type: Medium Page: 886

31. Following an acquisition, the acquiring firm's balance sheet shows an asset labeled "goodwill." What form of merger accounting is being used?

- A) Consolidation
- B) Aggregation
- C) Purchase
- D) None of the above

Answer: C Type: Easy Page: 887

32. The PEN Corporation with a book value of \$20 million and a market value of \$30 million has merged with the CNC Corporation with a book value of \$6 million and a market value of \$8 million at a price of \$9 million. If the transaction is a purchase then the total assets on the books of the new company will be:

- A) \$38 million
- B) \$39 million
- C) \$29 million
- D) \$26 million

Answer: B Type: Difficult Page: 887

Response: Purchase method: $30 + 8 + 1 = 39$

33. The DOC Corporation with a book value of \$20 million and a market value of \$30 million has merged with the CIC Corporation with a book value of \$6 million and a market value of \$8 million at a price of \$9 million. If the transaction is a purchase will there be any goodwill, and if so, what is the amount of goodwill?

- A) No goodwill; 0
- B) Yes goodwill; 3
- C) Yes goodwill; 1
- D) Cannot be calculated with the information given

Answer: C Type: Difficult Page: 887

Response: Purchase method: $MV(DOC) + MV(CEC) + Goodwill = 30 + 8 + 1 = 39$

34. If an acquisition is made using cash payment then the acquisition is:

- A) taxable
- B) viewed as exchanging of shares and is not taxed
- C) a tax-free transaction as no capital gains or losses are recognized
- D) none of the above

Answer: A Type: Medium Page: 888

35. The main difference in a tax-free versus taxable acquisition to the shareholders is that:

- (I) In a tax-free acquisition shares are only exchanged, while in a taxable transaction the shares are considered sold and realized capital gains or losses are taxed
- (II) In a tax-free acquisition a capital gain and loss are realized and then new shares issued, while in a taxable transaction the assets are revalued, taxed on any capital gains and losses and then shares exchanged
- (III) In a tax-free acquisition the shareholders simply take the cash and depart, while in a taxable transaction the shareholders must stay with the new entity

- A) I only
- B) II only
- C) III only
- D) I and III only

Answer: A Type: Difficult Page: 888

36. What are the tax consequences of a taxable merger?

- A) Selling shareholders can defer any capital gain until they sell their shares in the merged company
- B) Depreciation tax shield is unchanged by merger
- C) Selling shareholders must recognize any capital gain
- D) Depreciable value of assets will remain unchanged

Answer: C Type: Medium Page: 988

37. Which of the following factors influence the choice between merger and an acquisition of stock?

- (I) Shareholders are dealt with directly to bypass target management and board of directors
 - (II) In a tender offer, usually some minority shareholders do not tender stopping complete firm absorption
 - (III) Target management may be unfriendly and resist an offer. Resistance usually makes the stock price higher
- A) I only
 - B) II only
 - C) III only
 - D) I, II, and III

Answer: D Type: Difficult Page: 889

38. A dissident group solicits votes in an attempt to replace existing management. This is called a:

- A) Proxy fight
- B) Shareholder derivative action
- C) Tender offer
- D) Management freeze-out

Answer: A Type: Medium Page: 889

39. A modification of the corporate charter that requires 80% shareholder approval for takeover is called a(n):

- A) Repurchase standstill provision
- B) Exclusionary self-tender
- C) Super majority amendment
- D) Tender offer

Answer: C Type: Medium Page: 892

40. An example of a shark-repellent charter amendment is:

- (I) Supermajority
- (II) Waiting period
- (III) Poison pill
- (IV) Staggered board

- A) I only
- B) II only
- C) I and II only
- D) I, II, III, and IV

Answer: D Type: Medium Page: 892

41. Compensation paid to top management in the event of a takeover is called a:

- A) Poison pill
- B) Golden parachute
- C) Self-tender
- D) Buyout

Answer: B Type: Easy Page: 892

42. As a defensive maneuver, a firm issues deep-discount bonds that are redeemable at par in the event of an unfriendly takeover. These bonds are an example of:

- A) Greenmail
- B) A "scorched earth" policy
- C) Crown jewels
- D) A poison put

Answer: D Type: Medium Page: 892

True/False Questions

T F 43. The easiest task for the managers is the integration of the two firms.

Answer: False Type: Medium Page: 871

T F 44. A conglomerate merger is one in which a buyer buys a closely related firm.

Answer: False Type: Medium Page: 872

T F 45. A vertical merger is one in which the buyer expands forward in the direction of the ultimate consumer or backward toward the source of raw material.

Answer: True Type: Medium Page: 872

T F 46. Two companies should consider a merger if they have complementary resources.

Answer: True Type: Easy Page: 875

T F 47. Diversification is a very sensible reason for two companies to merge.

Answer: False Type: Medium Page: 877

T F 48. Gain from mergers is defined as: $\text{Gain} = PV_{AB} - (PV_A + PV_B)$.

Answer: True Type: Medium Page: 881

T F 49. If Firm A acquires Firm B for cash, then the cost of the merger is equal to the cash payment minus B's value as a separate entity.

Answer: True Type: Medium Page: 885

T F 50. In the purchase method of merger accounting a new asset category called goodwill is created.

Answer: True Type: Difficult Page: 887

T F 51. It appears that target companies capture most of the gains in hostile takeovers.

Answer: True Type: Medium Page: 891

Essay Questions

52. Briefly explain the different types of mergers.

Type: Medium Page: 871

Answer:

There are essentially three types of mergers: horizontal, vertical, and conglomerate. We can also add a new type that is the cross-border merger. A horizontal merger is one where two firms in the same line of business merge. A vertical merger is one where companies at different stages of production merge. A conglomerate merger involves companies in unrelated lines of business. A cross-border merger involves companies from different countries.

53. Discuss the difficulties associated with a typical merger.

Type: Difficult Page: 872

Answer:

The difficulties are numerous and easily overlooked. They include integration of product lines, processes, training, R and D etc. The biggest hurdle is the merging of two corporate cultures. Many

mergers have failed because of this.

54. Briefly explain the term "economies of scale."

Type: Medium Page: 873

Answer:

The natural goal of horizontal mergers is achieving economies of scale. Economies of scale are achieved when the average unit cost of production decreases as production increases. One way to achieve economies of scale is to spread fixed costs over a larger volume of production. Economies of scale are also claimed even in other types of mergers also. For example, in vertical mergers economies of scale are achieved through better coordination and administration, and through elimination of redundant costs.

55. Briefly explain some of the good motives for mergers.

Type: Medium Page: 873

Answer:

There are several good motives for mergers. They are: Economies of scale; economies of vertical integration; complementary resources; unused tax shields; surplus funds; eliminating inefficiencies. Of these economies of scale and complementary resources are the two widely known motives for mergers.

56. Briefly explain what is meant by "the Cost of acquiring" in the context of a merger?

Type: Medium Page: 881

Answer:

The cost of acquiring is the cash paid minus the value of the acquired firm as a separate entity. $\text{Cost} = \text{Cash paid} - \text{PV}_B$. This calculation becomes more complicated if the payment made is in the form of acquiring firm's stock.

57. Briefly explain what is meant by economic gain from merger?

Type: Medium Page: 881

Answer:

There is an economic gain only if the two firms that are merging are worth more together than apart.

$$\text{Gain} = \text{PV}_{AB} - (\text{PV}_A + \text{PV}_B) > 0$$

58. Explain the central tenet of the Clayton Act of 1914.

Type: Medium Page: 886

Answer:

The Clayton Act of 1914 forbids an acquisition whenever "in any line of commerce or in any section of the country" the effect "may be substantially to lessen competition or to tend to create a monopoly." This is enforced either by a civil suit brought by the Justice Department or by a proceeding initiated by the Federal Trade Commission (FTC).

59. Name the agencies that have successfully blocked mergers on antitrust (antimonopoly) grounds.

Type: Medium Page: 886

Answer:

The US Justice Department and the Federal trade commission (FTC) have, in the past, successfully blocked several large mergers. For example Reynolds and Alcoa, WorldCom and Sprint, Hollywood Entertainment and Blockbuster, and office Depot and Staples mergers were blocked on antitrust grounds. Recently, European Commission blocked the merger between GE and Honeywell.

60. Briefly discuss different forms of acquisition.

Type: Difficult Page: 887

Answer:

Basically an acquisition can take three forms. First approach is for one company to automatically assume all the assets and all the liabilities of the other company. Second, is to buy the seller's stock in exchange for cash, shares, or other securities. The third approach is to buy some or all of the seller's assets.

61. Briefly discuss takeover defenses.

Type: Difficult Page: 892

Answer:

The main purpose of takeover defenses is to raise the price an acquiring firm must pay to take over a firm. Examples of defensive tactics include the supermajority amendment, restricted voting rights, poison pill, litigation etc. Finally the bondholders gain quite substantially from mergers.