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CGMA NOVEMBER 2015 EXAM ANSWERS

Variant 3

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SECTION 1

Exploitable synergies

The business plan underlying this merger seems to be that we can supply a raw material that Darrell uses in manufacturing its finished product. That clearly provides some basis for mutual benefit because it can secure supplies of raw materials while we can benefit from a steady stream of revenue.

The basic premise underlying this proposal seems slightly flawed. We supply a basic commodity that is sold at a price that is set by the market. Darrell is looking for regular supplies of that product, but there is no great difficulty in locating sellers. There should be no reason to believe that Darrell will ever struggle to find supplies of timber on the open market. There are lots of forests and there is no reason to believe that supplies will ever be erratic or volatile. Timber is grown locally and can also be imported easily from countries that are politically secure.

As a supplier, we are forced to accept the market price. If we merge then we can add some value to this output by converting it into MDF before selling it on. However, MDF is a basic commodity that will have a generic market price and so we will be subject to very similar market prices that may do very little to enhance our profitability. If anything, an ongoing commitment to keep an MDF factory operating at full capacity could reduce our scope to sell timber for other purposes.

If there is indeed a benefit to this merger then we could consider the possibility of building our own MDF factory or signing an exclusive contract to supply another company that manufactures MDF. There is very little synergy from the merger if we can obtain the same benefit more cheaply, without risking the dilution of our equity.

There could be other benefits to this merger. Wodd will be able to invest less time and energy in sales and distribution because much of our output will simply be shipped to the MDF factory. Darrell will be able to avoid some of the costs associated with placing orders and making payments. Unfortunately, those savings may prove difficult to realise. Wodd's marketing department may resist the loss of staff and it may prove difficult to reduce staffing levels to the extent we would have hoped. Many of Darrell's administrative systems will be so highly automated that the marginal costs associated with internal transfers of materials will be close to zero. Once a system using, say, Electronic Data Interchange is up and running there will be very little benefit to reducing the number of purchases and payments because the software will handle most of the processing.

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We have a fairly healthy cash position and we understand Darrell's business. That suggests that a merger might be in both companies' interests because they would get the benefit of a cash injection and we would be able to put our cash balance to good use.

Ethical breach?

There are a number of ethical issues arising from his conversation and the associated request.

The discussions concerning the merger have to be viewed as commercially sensitive. If our interest in the merger becomes known then Darrell's share price could increase, which would make it more expensive for Wodd to acquire control. Clearly, the more people who know about the discussions, the greater the risk of a leak.

I have no specific duty to inform my immediate superior of every piece of information that I receive. It is an unusual request, but it does not place me in breach of any specific duty to Marcus.

Offset against that, it appears to be general knowledge that Darrell is actively seeking a merger. The market may not know of Wodd's specific interest, but it is very possible that Darrell's share price has already been inflated by the likelihood of a merger.

We have the fact that the details of the discussions are being withheld from Wodd's executive directors. It is worrying that the chairman does not feel able to trust them, while choosing to confide in a more junior member of staff. It would be helpful to be briefed on why the executive board cannot be briefed, if only because they are colleagues whose jobs may be at risk and they have a right to know.

I may have a personal liability here and so I might have to consider the cost of agreeing to this request.

There could be a concern that the secretive nature of the discussions between the two chairmen will later lead to them being accused of some sort of underhand or unscrupulous behaviour. If it was later discovered that I had been involved in discussions then I might be accused also. That does not, in itself, create a duty to disclose this conversation, but it would create a duty to protect myself by seeking greater transparency.

The fact that Darrell's previous attempts to merge have failed add to this concern because they suggest that the company has problems and so it might not be in Wodd's best interests to pursue this merger. That would suggest that Wodd's Board should be briefed and that I should not be participating in any form of secretive discussions.

I am also in danger of damaging my working relationship with my immediate superior. Again, that could lead to a personal cost if Marcus realises that I have kept such important information from him.

If I agree to keep your confidence then I will, of course, be bound by that commitment.

Section 2

Response to Market Blogger

These comments fail to recognise the factors that affect share prices in a merger. They also demonstrate a lack of understanding of share price movements.

The most important issue from the perspective of Wodd's shareholders is that the share price has increased. If we attribute that increase to the announcement then the market views that as 'good' news. This can be interpreted in two ways.

The more favourable interpretation is that the market believes that the merger will create synergies that will benefit Wodd's existing shareholders. This could be due to economies of scale or scope that will be to Wodd's overall advantage. In terms of the immediate implications for Wodd, it makes little sense to argue that Darrell's shareholders may be receiving a greater share of the benefit. Our share price has increased by almost 25%.

A less savoury interpretation of the facts is that there may be buyers who are keen to profit by disrupting the merger. Buying shares in either, or both, companies gives these investors scope to vote against it. It may be that they will threaten to disrupt the merger unless they are bought out at a premium or they receive more shares than are strictly fair in terms of the merger. Even that is a positive sign, because such a speculative investment would only make sense if the buyers have reason to believe that the merger will be attractive to both companies' shareholders.

The fact that Darrell's shares have increased more significantly could imply that Wodd's Board has offered Darrell's shareholders too large a proportion of the merged company's shares. However, that is by no means the only explanation.

In an efficient market, the share price reflects all available information. As far as the markets are concerned, Darrell had been trying and failing to find a counterparty to merge with. The markets clearly viewed Darrell's attempts to merge as doomed and so there was a more significant information content to the news that a potential partner had been found.

It seems reasonable to argue that the positive news about the merger was of greater value to Darrell's shareholders because the company is running into severe difficulties, both in terms of supplying its factory with raw materials and also because of a weak cash position. The merger will rectify these shortcomings and so Darrell's share price has increased disproportionately. The benefit that is being enjoyed by Darrell does not necessarily mean that Wodd can demand a disproportionate share of the benefits. The terms of the merger should also allow for the value of the merged entity after the merger has been completed and Darrell is likely to make a significant contribution to that intrinsic value once its major concerns have been rectified.

Any shareholder who decides to switch companies at this stage may be disappointed. The share prices have already reacted to the news of the merger and, at least in theory, will not necessarily continue to increase in the future. Any further movements will depend on fresh news becoming available to the market.

Negotiating strategy

The starting point is to determine what we wish to obtain from this merger. We are either going to create a new company, which will exchange its shares for those of Wodd and Darrell in order to create a completely new company or we will designate either Wodd or Darrell as the parent company and will exchange shares in that company for those of the other.

The key to maximising the wealth of Wodd's existing shareholders is to ensure that they have the greatest possible share of the equity of the merged parent company. Wodd's Board has

to develop a realistic set of arguments for maximising that share, although it has to be careful not to overdo things to such an extent that Darrell's shareholders refuse to proceed. It may be better in the long run to aim for a 'fair' share, rather than being greedy and demanding an excessive share of the total and then having to spend time and money on a renegotiation.

It should be borne in mind that these negotiations will have little effect on the merged company once it is created. The shareholders will have no direct say in the running of the company once the merger takes place and so there is little to be gained or lost from making Darrell's shareholders happy, provided they sign the agreement to merge.

We should gather facts and figures that would support our case and then use them selectively, bearing in mind that Darrell's Board is likely to do the same to us. We should certainly consider the market capitalisation of the two companies as a starting point for negotiations. We could argue that Wodd's value as a proportion of the total for the two companies would be a realistic basis. Given the increase in share prices and the fact that Darrell increased by more than Wodd, we might argue that we should use the market capitalisation before the merger was announced because that would reflect the basic value of both companies.

We need to consider the contribution that each company will make to future profits. We need to be careful here because Darrell owns the MDF factory. If Darrell's overall profit is going to be higher than Wodd's because of the factory we need to be ready to argue that the MDF factory is only generating a contribution because of raw materials and/or finance supplied by Wodd.

We might argue that Wodd's shareholders are taking the greater risk and so they should be compensated by awarding them a greater proportion of the shares. Wodd's business model is the simpler of the two because it simply grows timber and sells it to a market that can put this product to a host of different uses. Darrell has committed itself to processing some of its timber output to MDF, which may mean that its markets are a little narrower.

Wodd's shareholders may also judge our negotiating strategy by referring to the management team in the new company. They may feel that their interests are being better taken care of if Wodd's board dominates the new company rather than Darrell's. This is likely to prove a rather contentious area for negotiation, although we need to expect it to be raised as an issue because all Board members will be concerned for their own jobs.

Section 3

Natural hedging v derivatives

It isn't necessarily clear that one approach will always be better than the other.

Natural hedging is generally simpler and cheaper to operate. For example, if we export goods to Eurozone customers then we will have trade receivables denominated in Euros. We could arrange a natural hedge by structuring our operation so that we import and pay for goods in Euros. That way, any losses on our receivables will be offset by gains on our payables. We could hedge receivables using derivatives, but some would involve the payment of a premium and others might require us to lodge cash as a margin.

Natural hedging offers other benefits. For example, our natural hedge on the Euro would give us some protection against economic exposure. We would have to buy quite substantial quantities of derivatives to obtain the same degree of protection and the resulting positions would be extremely difficult to manage,

It is not always possible to use natural hedging, whereas derivatives can be very versatile. For example, we may not be able to structure our costs so that they are denominated in Euros, or any other currency for that matter. We are a forestry company and most of our expenses will be incurred locally.

Natural hedging can also have some hidden, or opportunity, costs. For example, importing goods for the sake of hedging could lead to us paying more for them after transport and other costs are taken into account.

Selecting the better treasurer

A good treasurer can do a great deal to secure our financing and to manage our cash flows.

Our starting point should be to consider which bank we plan to use after the merger. A good treasurer will develop a strong relationship with the bank and will have good contacts with lending officers and so on. It would make sense to consider using the treasurer whose bank will handle our business.

The treasurer's experience and qualifications are also important. Professional qualifications generally require their holders to participate in continuing professional development so that their skills remain up to date. Membership also imposes ethical requirement codes that may enhance the treasurer's reputation.

The treasurer will also have to motivate and manage a team. Leadership skills and experience could be a vital complement to technical skills in managing the treasury department.

Retaining staff

The arguments that have been put forward don't necessarily follow. The use of big data does not necessarily require a large number of staff for data processing.

In the short term, it may require some expertise to consolidate both companies' data sets and to remove any duplicates of external data points. It may be necessary to keep a number of the IT staff from both companies on the payroll so that they can assist with the consolidation process. Once the new system is up and running, it should be possible to rationalise the system by paying off a number of IT staff and relying on automated processes.

As the merged business progresses, it may need to recruit specialists who can consider the ways in which big data might be useful for planning and management. It does not sound as if either department actually has that expertise at present and retaining the existing headcount may actually mean that there is less funding available to bring in the new skills that are required.

The only real justification for retaining both sets of staff would be if the systems themselves were left to operate independently as before. In that case the staff would have to be retained from both companies to keep both systems running, but that would probably mean that the anticipated use of big data might not be possible.

Challenges

The two heads of IT are effectively demonstrating one of the problems associated with exploiting synergies in the aftermath of a merger. Department heads often resist redundancies and so anticipated rationalisation does not always occur as it should. Managers are motivated by loyalty to their colleagues and also a desire to build up their departments.

One approach might be to make it clear that only one head of IT is necessary and that the company will put the person who comes up with the most efficient plan to rationalise the two systems will be kept on and the other will be made redundant. The fact that the person whose plan is selected must then put it into operation will create an incentive to make the plan realistic and workable.

Another possibility would be to offer staff a voluntary redundancy scheme, so that volunteers might come forward. This would take some of the pressure off the managers if their colleagues were actually keen to leave in return for a redundancy or early retirement package.

The managers might be given some discretion over the application of their total budget, so that they could retain some of the savings in staff costs to spend on hardware, software or training. The professional opportunities that might create could counter the desire to retain staff.