PRACTICAL ASPECTS OF VALUATIONS FOR MERGERS AND DIVISIONS

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(Received December 2014; accepted January 2015)

Abstract
The purpose of this article is to present the main problems posed by mergers and divisions, to valuators and experts, called to certify their correctness. This material summarizes the main Romanian and European legislative norms in the field, and shows, through a series of practical examples, which should be the internal legislative changes, in order to avoid logical contradictions, that may arise. This paper proposes a number of solutions and invites professionals and corporations to contribute to legislative regulation of reported issues.
Keywords: Valuation, Merger, Division, Exchange Rate, Stock Exchange, Public Offer.
JEL Classification: G340

1. Introduction

Mergers and divisions are regulated both at national and European level. In Romania, corporate restructuring activities of this type may involve up to three separate types of valuation:
1) Valuation of participating companies, for the correct assessment of the exchange rate (ratio) of shares;
2) Share valuation, to ensure protection for minority shareholders, who disagree with the operation, and wish the society to redeem their shares; and
3) Valuation for a possible public offer mandatory on the capital market (in case a shareholder exceeds the threshold control)
Unfortunately, each of these valuations are governed by different legal rules, some contradictory (in itself, or among each other), which can create confusion for experts and/or shareholders.

2. Methodology

The problems highlighted in this material come entirely from the authors practice.

From the accumulated observations, a series of legislative gaps, inconsitencies and even mathematical errors have been reported. Therefore, the authors conducted a careful analysis of the legislative rules directly involved in the merger/division operations. The analysis regarding valuations of these corporate operations was carried on, international bibliography of the field beeing studied in comparison with internal norms. The conclusions are based on deduction of the most logical proposals to improve legislation and practice of merger/division operations, as well as of related valuations.

3. Results and discussions

The main results can be syntethized as it follows:

- A series of legislative inaccuracies have been noticed, related to the way the rate of exchange is calculated in the cases of mergers and divisions.
- A series of contradictory norms regarding share valuation in the processess of restructuring, have been reported.
- Discrepancies between normative acts, which regulate different connex aspects of operations, have been reported and analyzed.

Alongside this deficiences, the authors have suggested a series of legislative, normative and procedural changes. The proposals create a frame for academic and practicioners debate regarding the elimination of discrepancies and unification of merger/divison related valuations. Some issues still remain open to debate, the authors proposed alternative options and made available for legislators and practicioners alternatives, whose selection depende on the professional reasoning of each case in part.

4. Legal Framework

At European level, the operations are governed by a series of acts: Directive 2011/35/EU, Council Directive 2009/133/EC, Sixth Council Directive 82/891/EEC, and on the related and modified documents. Enterprise acquisitions accounting are based on IFRS rules, and the valuation is based on the transportation into nation law of the International Valuation Standards developed by IVSC.

The provisions of these European standards are transported into Romanian legislation in the Company Act and in the Tax Code. The only piece of legislation, still in force, which governs the calculation of the exchange rate, is OMF 1376/2004. Being largely obsolete, the Ministry of Finance has posted at decisional transparency, a revised version of decision rules.

5. Companies Merger

In the international reference literature it is highlighted (Galpin 2014, DePamphilis 2012, 2011), the issue of valuation for mergers (Petitt 2013, Melka 2013) largely confines in establishing the value of the absorbed company and setting the correct amount to redeem the stakeholders for the take over (Baker 2011) (hostile or not).

This present paper is mainly concerned with domestic legislative issues, which affect the valuations, made during mergers (and divisions).

5.1. Valuation for establishing the rate of exchange

When a company acquires another company by merger, the assets and liabilities are fully transferred to the acquiring company, and the shareholders of the acquired company become shareholders of the merged company. Obviously, the process must be conducted in such a manner that the shareholders' wealth (value of equity holdings) will remain constant. In this case, the exchange rate is calculated, as the ratio between the share value of the acquired company and the share value of the acquiring company. Allocation of additional shares, to the stakeholders of the acquired company, will be made by multiplying their original number of shares, with the exchange rate.

The principle is shown in the first example, synthesized in Table 1. It is noted that company **R** is „weaker", the net asset being half of the net asset of the absorbing company **P**, so in order to assure the equity of the operation, its shareholders will not receive 200,000 share in company **P** (as many as they own in **R**), but only ½ of this number: 100,000 shares.

Table 1. Exchange rate calculation

Indicator	**Company P absorbing**	**Company R absorbed**	**Company P merged**
Net asset value	800,000	400,000	1,200,000
No of shares	200,000	200,000	300,000
Nominal value	1	1	1
Net asset value/share	4	2	4
Exchange rate		1/2	

The exchange rate is calculated as the ratio between the net asset value (NAV) of the acquired company divided to the NAV of the acquiring company. The nominal value must remain equal, in order to ensure the dimensional uniformity of the formulas.

5.2. The case of negative net asset

The first problem arises when one of the participants in the merger has a negative assessed value. Using the previous reasoning, it is clear that the shareholders of the absorbed company (which has negative net value) will have no shares allotted in the absorbing company, because a negative exchange rate has no economic sense.

This case raises several problems. Through this operations, the stakeholders of the absorbed company lose their holdings (which, anyway have no value), and the value of holdings of the stakeholders of the absorbing company, will decrease (because the total net asset of the merged company decreases, but the number of shares remains constant). Why would this situation be acceptable? There may be several explanations:

- The valuation in not correct. Intangible assets, contingent assets, liabilities (not included in accounting), possible contracts, etc may have been omitted.

- The merger creates synergic effects. In this case, the value of the beneficiary company should be re-evaluated, and the generated added value must be assigned (possibly, partially) to the absorbed company.
- Shareholders are the same in both societies, in which case the accumulated losses of the absorbed company may be covered by the profit (and/or retained earnings) of the absorbing company. The merger must demonstrate it has economic reasons, and is not a tax evasion operation.

The merger entrance, of a negative valuated company, may be an alternative to bankruptcy proceedings. I believe that valuators and experts, who examine the project, should seek a monetary term, which should explain the motivation, for which the shareholders of the absorbed company are willing to fully and immediately give up their shares, respectively, the decision of the absorbing company's' shareholders to take the negative net assets.

The situation of the negative net asset is legally possible: in this case, according to the Art. 153 of law 31/90, the company may be dissolved (fact which is anyway done by its absorption), or it may adjust the minimum capital up to half of the share capital. However, in order for the fusion operation to be logical, it would be normal that the absorbed society to be obliged to increase its net asset before the fusion (possibly by private contribution of its stakeholders), at least up to a positive value.

According to existing rules, the case in which the absorbing company has negative net asset is treated differently, due to the fact that it is imposed to take into account the nominal value for the rate of exchange calculation. Obviously, this implies an error of reasoning: the role of the absorbed and the absorbing company is formal, the positions being interchangeable from economic perspectives.

Noticing the paradox, the Minister of Finance, states through a proposal, to amend the rules, so that the shares' value of the absorbing company with net negative asset will be determined by the General Meeting of Shareholders (GMS). The proposed option does not solve the exposed problem (motivation of such an operation and proper valuation); it only transfers it to the shareholders of the benefiting company.

5.3. Treatment of mutual shareholdings

Table 2. Anomalies resulted from mutual equity valuation

Indicator	Company M	Company N	Company M
	Absorbing	Absorbed	Merged
Net asset value	2,000,000	750,000	2,550,000
No of shares	80,000	50,000	110,000
Nominal value	17.00	12.00	17.00
Net asset value/share	25.00	15.00	23.18
Exchange rate		3/5	

Mutual actions are reevaluated and taken into consideration when calculating the rate of exchange, although they are to be abrogated.

In another example presented in the Norms, the absorbed company **N** owns 10% of the capital of the absorbing company **M**. These were included in the calculation of net assets, but were subsequently abrogated, according to the legal norms. The calculation is shown in Table 2.

The fact that the merged company's shareholders NAV value has decreased after the merger, contravenes the principle, which states that the exchange rate should provide the wealth preservation of the shareholders. The anomaly is not due to a mathematical error, but instead it is caused by the following effect of the law: the shares owned by **N** in **M** were reevaluated at market share (25 lei/share), but were later abrogated, thus reducing the equity of the absorbing company.

The proposed solutions can rectify the situation:

- Selling the cross-holdings to a third party, before the merger. The effect is the possible cooptation of external shareholders, but in return, it provides full correctness of operations.
- Dividing the company **N**, prior to the merger, by transferring the shares of the company **M** and proportional assigning the shares in the daughter company. In this way, the value of the shareholders is preserved, but the voting rights are altered. In the newly formed company, the equity will be identical to that of **N**, but the voting right in the merged company **M** will be decided by the major stakeholder, who votes on behalf of all holdings of merged company, in GMS from **M**.
- Allowing the possession, for a period not exceeding one year, of own shares. Theoretically this contradicts Romanian and European laws, but if the holdings are small enough not to affect the decisions of the merged company, the compromise would be beneficial, especially since the synergetic effects of the merger may be felt, and the shares could be sold, to third parties, at higher prices.
- If the shares owned by **N** in **M** are to be abrogated, their value should be 0 from the start. The stakeholders of **N** company may regard themselves as disadvantaged, but will eventually acknowledge that they either accept the situation or the company sells their shares and they keep their wealth.
- Finally, if shareholders are the same in both companies, cross-holdings may be sold even to **M** company, which has the right (within legal limits) to redeem its own shares.

6. The issue of divisions

Apparently, a division is a reverse merger process. No legal norm provides this condition: checking the correctness of a division is not made arithmetically, by the theoretical merging the beneficiaries and comparing the results with the initial company. This check happens only when the beneficiaries have the same NAV.

Proportional division of all assets and liabilities (the only one dealt in OMF 1376/2004) may violate the tax requirement, which states that the detached part of the divided society must constitute in a branch of activity, which can operate independently from an economic point of view. Usually, the separation of a branch

does not lead to a stable balance sheet (where the asset is equal to the liabilities), so distributions will be required, from accounts whose origin can not be attributed, directly or based on proportionality, to any recipient: availability, premium shares, reserves, retained profits, etc.

If the shares are distributed proportional with the initial holdings, no problem will arise: shareholders' equity will be distributed in several companies, maintaining the same rate of participation, instead of having their holdings concentrated in a single company.

If the shares are not distributed in the same proportion in the divided company and in the beneficiary ones, but the net asset value is similar, again there is no problem: the holdings of each shareholder are preserved.

The problem may arise when the shares are not proportionally distributed, and the NAV value is different in the recipients. Theoretically, some shareholders will be disadvantaged and others will benefit. What arguments could the expert bring to demonstrate that the division is still correct? In this sense, we emphasis the following hypothesis:

- Shareholders have a gentlemen's agreement. This agreement must be assessed in monetary terms, in such a way that the benefits be taken into consideration as intangible assets.
- Stakeholders have misunderstandings, so they prefer the separation in any conditions. The effect is the reverse of synergy, but projected cash-flows demonstrate the viability of the solution.
- According to Boston Consulting Group Matrix, traditional activities (*Cash Cows* – with slow growth, but significant market share) can sustain and help growth potential activities, with low market share (*Question* Marks) - Figure 1.

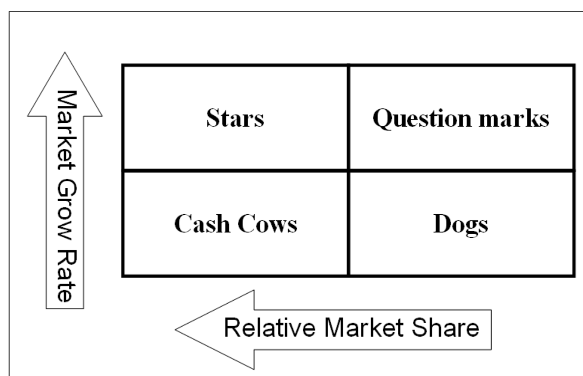

Figure 1. Boston Consulting Group Matrix

Classification of distinct activities, from a company, is essential for defining the concept of division in favor of shareholder.

It is possible for some partners to decide to take one of the perspective activities, while others are no longer willing to finance them, due to the fact that they are

risky. Forecasted cash-flows should demonstrate that the separation is viable and preferable to cohabitation.

7. Valuation for protecting minority shareholders

Minority shareholders have no decision-making power to prevent a merger or a division, approved by the majority. European legislation provides adequate protection (share redemption at fair value) in certain situations:

- If the parent company absorbs the daughter company (in which it holds at least 90%) and no publicity is made;
- If the stakeholders of the beneficiary company are not assigned shares in proportion to the shares held in the divided company.

Romanian law makes no distinctions, and allows any shareholder to withdraw from the company, and its shares holdings to be redeemed, if he did not voted in favor of a merger or division resolution in GMS. The requirement is not justified if the project has been properly compiled and verified by experts, and the additional protection of minority stakeholders is not, in itself, objectionable.

But the express provision (art. 134 al (4) of Law 31/90), which states the following, is completely unjustified: *„The price paid by the company for the shares of the person that exercises the withdrawal right shall be established by an independent authorized expert,* ***as the average value resulted from the application of at least two evaluation methods****, recognized by the legislation in force on the date of evaluation".*

There is logic in imposing the calculation of an average value: the value of the shares of those wishing to exit may be affected by minority discounts and/or illiquidity and/or marketability. Maybe in this way the legislator tried to find a value lying between the expectations of the minority shareholders and the willingness to pay of the main shareholder. But in what concerns the valuation process, we appreciate the introduction of this provision as being an uninspired choice, mainly because European legislation only provides that: *„in the event of disagreement regarding such consideration, it must be possible for the value of the consideration to be determined by a court or by an administrative authority designated by the Member State for that purpose".*

The first counterargument against imposing the average is that the exchange rate should be determined based either on the net asset, or by valuation (in OMF 1376/2004 is mentioned: *„cost-approach method or net asset method, stock method, result oriented method (rate of return value, yield value, the over-profit value), mix methods and cash-flow method)"*. Valuating the shares of the minority by averaging two values can substantially differ from the net contribution value, established by the splitting/merging project, creating a natural confusion among the participants.

Secondly, establishing the approach and the reconciliation of the values must belong exclusively to the valuator. Valuation standards and ANEVAR rules recommend selecting the most justified value, under no circumstances the necessity for applying any average. There are situations where the valuator can not determine

more values (is required, for example, to propose the liquidation value of the company). Therefore, we believe that the legal provision regarding the mandatory use of average in valuations should be eliminated.

8. Takeover bids

According to the Capital Market Law and Regulation no. 1/2006, *„achieving a position representing more than 33% of the voting rights of the issuer is considered unintentional, if it was realized as an effect of operations such as: merger/division or succession. "In this case, the shareholder in question has one of the following alternative obligations: a) to conduct a public offering; or b) to dispose a number of shares, corresponding with losing the position acquired without intention."*

Furthermore, the European legislation (Directive 2004/25) reinforces the obligativity of the public offer, but only if the surpassing of the threshold, was the result of market acquisitions, and the fair price is considered the maximum price paid by the bidder in a previous period of 6÷12 months. In special situations (handling assumptions), *„Member States may also determine the criteria, which are to be applied in such cases, for instance the average market value over a given period, the liquidation value of the company, or other objective valuation criteria, used in financial analysis. Any decision, that adjusts the equitable price, of the supervising authority, must be substantiated and made public."*

In Romania, the public offer is mandatory, and under capital market law, if statutory deadlines are met, and the one who offers has not acquired shares in the last year, „**the price offered in the takeover bid will be at least equal to the highest price of the following values determined by an authorized valuator,** designated by the tenderer:

a) *weighted average trading price, of the last 12 months preceding the date of submission to the FSA of tender documentation;*

b) the value of the net asset divided by the number of outstanding shares, according to the latest audited financial statement;

c) the value of shares, resulted from an expertise, carried out in accordance to international valuation standards."

Although this time the legislator did not interfere in the valuation process (value determined at point c) is without restrictions), the price, offered to the minority, is still determined as a maximum value, not a selected or reconciled one. Imposing a maximum value, probably results from the intention of former CNVM (current FSA, regulatory and control body of the capital market), in the absence of an industry of voting consultants (proxy advisors), to protect minority shareholders from possible abuses by the majority.

Companies listed on regulated markets should apply IFRS standards for accounting reports. Accordingly, the audited financial statements should present all net assets and liabilities at fair value, so that the net asset value of the issuer should not substantially differ from the value obtained through economic methods. However, the IVS 200 Businesses and Business Interests standard states that: *„The market and the income approaches ... can be applied to the valuation of a business or*

business interest. The cost approach cannot normally be applied except in the case of early stage or start-up businesses where profits and/or cash-flow cannot be reliable determined and adequate market information is available on the entity's assets." – which is not the case, normally, for listed issuers. Therefore, capital market legislation should be adapted to the changes in valuation standards.

Also, the practical application of the calculations may lead to some unnatural situations:

- It is possible, the allocation of shares at a certain value (by calculating the exchange rate), the withdrawal of shares at another value (an average of 2÷3 values), and the public offer to be made, at yet another value (maximum of 3 values, which may themselves differ from the others mentioned above).
- Rational speaking, due to the fact that the exchange rate does not account for minority discounts, the allocation of shares should be the best option for minority shareholders, because they are treated equally with the majority. Valuations for their potential exit (either as a result of challenging the merger/division or by subscribing in the public offer) should not produce a higher price. Majority shareholders receive holdings according to the exchange rate; it is impossible to expect them to offer the minority a higher price, if the exchange rate was correctly determined!
- Exceeding the control share is not accomplished through transactions, but by a mathematical calculation: the allocation of shares based on the exchange rate. The price, at which shares were traded on the stock market, can be radically different from that used in calculating the rate of exchange. Calculating an average over a period of one year does not take into account market fluctuations, in case of high volatility.

Figure 2. The evolution of the stock market index, BET

1 year intervals (framed rectangles) demonstrate that there are periods where values change very little, or increase or fall dramatically. Hence, setting a value based on the average of the last year has nothing to do with the evolution or the outlook of the market. Graph conducted on ifbfinwest.ro website.

Figure 2 shows the evolution of the domestic stock market, identifying periods of 1 year (bold rectangles). For each rectangle, it is obvious that the annual average is unrelated to the market price at the end of the year. Moreover, for liquid securities traded on regulated markets, it is natural the valuation of minority shareholders to be made through the mark-to-market model, at the valuation date.

If the 3 months statutory period for initiation of the public offer is not respected, the maximum paid price by the bidder, in the last year before exceeding the quota control, comes into discussion. Getting back to the graph in Figure 2, it is obvious, that in this case the weighted average purchase price should have been calculated, as being substantially more relevant than the maximum (usually, investors allocate a lump sum for acquisitions – the total budget, which they manage and falls in line with the market).

9. Conclusions

Valuators must respect both IVSC standards and national legislation. Currently, these provisions are not integrated; a share can not generate three different values in the same market conditions.

In our opinion, without future legislative constraints (based only on a proper judgment), the valuator should:

- Establish the exchange rate by valuating in favor of majority stakeholders. It is natural because they are primarily affected by the operation.
- For the withdrawal of shareholders who oppose the operation, the valuator must justify whether or not to apply a minority discount. No matter in which way the exit announcement (by not voting in the GMS or the control stake was transferred), the price should be similar.
- If the legislator considers that, giving the current market conditions in Romania, the imposition of a minimum price can not be waived, the valuator must notify shareholders, at the outset, and they must include in the division/merger project, the price which is to be offered to withdrawn shareholders. The requirement is included in the capital market law, but under insufficient form of the obligativity to mention the price in the project, only if one of the beneficiary does not remain listed.
- With help from models such as BCG matrix, the experts must define the financial relations between the various fields of the companies involved and to demonstrate that the merger/division produces global economic effects in the new organizational structure.
- Valuation through income should be the most relevant, although the cost approach (net asset value) is most commonly used in Romania. Profitability methods should be extremely well-founded, because operations are likely to affect the business continuity principle. Businesses are carried on by the beneficiary, but the aim of a merger/division is to separate/conjunct activities and continue on improved economic bases.

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