Mergers & Acquisitions and Credit Structures A Bank's Perspective

Merger & Acquisition is a key corporate business activity.

The merger of corporate entities necessitates the use of a credit solution that enables the effective and seamless transition of underlying entities such as the present and past credit landscapes to the new structure while continuing to support the post-merger day-to-day credit workflows.

Executive Summary

In recent years, the corporate sector has been witnessing significant merger and acquisition activities. Many corporate firms are exploring potential deals to cooperate with or absorb complementary firms. Several factors, including the firm's size or organizational structure across segments, expansion and increasing market presence, product and service offerings, and tangible assets drive these deals. A well-executed M&A deal can help accelerate growth and improve a firm's strength in the marketplace. However, these major transactions pose several integration challenges for the firms as well as their corporate banks in terms of transferring control to a single entity and consolidating existing and acquired entities and the credit lines offered.

A corporate bank that is tasked with protecting the interests of both firms in an M&A relationship needs to overcome the challenges of the new organizational hierarchy and associated credit structures using a solution that will help both the firms optimize value and achieve all the objectives of the engagement. For this, the bank must identify the challenges (both financial and regulatory), dependencies, and opportunities presented by the existing credit hierarchy, including the underlying credit lines and exposures. It must then create and execute plans for consolidating these based on the corporate structure and finally execute the consolidation plan in a way that minimizes the confusion for the customer, enables seamless integration, and continues to support the day-to-day transactions with the new credit hierarchy after the M&A activity.

Forms of Cooperation between Business – Basics (3)

Contractual

Non-Equity Alliance

Equity Alliance

Joint Ventures

Mergers and Acquisitions

Depth of Integration

The Challenges of Mergers and Acquisitions – Entity and its Credit

According to a research conducted by Deloitte in 2018, the year 2018 witnessed a total of 258 M&A deals globally, with an average deal value of US $191 million. The number of megadeals (deals valued at US $10 billion or more) was 32, which increased to 38 in 2019.

This, however, was what we today refer to as pre-pandemic period. Year 2020 began on a promising note but when the Covid-19 pandemic hit, many businesses had to go on the defensive, faced by unprecedented challenges in managing remote workforces, disrupted supply chains, highly volatile financing markets, and unpredictable revenue outlooks.

However, recent studies by Deloitte (1) (2) and Boston Consulting Group (3), predict that M&A volumes are expected to return to pre-pandemic levels within 12 months, backed by the roaring recovery over the past six months. One of the key drivers for the recovery is that the firms are recognizing the need to adapt to the new normal with increasing focus on virtual and digital consumer activities (e-commerce, no-contact purchases, digital, etc.). This trend is not just limited to sectors such as BFSI, technology, media, telecommunications, and consumer goods but is also true for large industrial sectors. In fact, the pandemic has accelerated the trend of long-term M&As instead of materially disrupting them.

An M&A process can be broadly categorized as a horizontal merger, vertical merger, and/or a conglomerate merger (4). Depending on the nature and structure of the new entity, the type of M&A influences the provision of credit to different customer groups based on the bank's policies and thus affects the value of collaterals and on the availability of credit to the new entity, which would require collaterals to obtain funds.

Amid all these moving parts in an M&A, banks often overlook the process of integrating the different entities under a single hierarchical umbrella to achieve the desired corporate structure. This stems from the assumption that the underlying technology and systems are efficient enough to restructure the corporate hierarchy and realign the credit allocated and consumed by the entities accordingly. However, internal policies of a bank drive the complex workflows that determine the overall credit availability to a firm, right from the top to the very bottom of its structure – including allocations for general or specific projects. In addition, an M&A is traditionally treated as a specialized activity related to investment banking and is often not a part of the traditional credit application systems in a corporate banking environment.

The underlying systems that enable effective transition in a way that resonates with the new entity structure and simplifies day-to-day credit workflows are extremely significant as it they can potentially minimize confusion by bringing the disparate corporate entities together.

M&A – By the Numbers (2) (3)

40 to 70 transactions per month in the past ten years for M&A deals valued at more than $500 million since 2007.

Monthly deal activity exceeded **40 transactions** during Jun 2020-Aug 2020.

75% of businesses say that downturns are a good time for mergers and acquisitions.

42% of executives polled at US corporations and PE firms expect M&A volume to return to pre-COVID-19 activity levels within 12 months.

Seamless Transition of Entity Hierarchies and their Credit Landscape

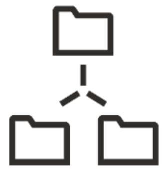
Mergers and acquisitions typically result in the consolidation of two businesses with net synergies that increase the value of the newly created business entity. Typically, an M&A process consists of three distinct stages: the vision phase, the due diligence phase, and the integration phase [(5)]. It is essential that the entity's bank is aware of the typical final corporate structure that they are heading towards during each of the phases even though the actual transition of entities takes place only during the integration phase.

Based on the type of amalgamation, there can be three types of M&A deals:

1. A corporation acquires control of another independent entity.
2. A corporation acquires control of another corporate, which might be a subsidiary.
3. A corporate firm spins off as an independent separate entity – demerger.

Because the allocation of credit in a bank is heavily dependent on the policies and exposure appetite, the banks should develop a deep understanding of the organizations involved, including their existing credit landscape, for any of the scenarios. The bank should carefully consider what they will need to change or retain in the newly formed organization's structure, including the credit availability and consumption, and assess the resources needed to drive the transition. Additionally, bank should also delve deep into the details of complex subjects such as credit utilizations, credit earmarking, credit hierarchies, exposures and historical credit data, underlying assets, and post transfer credit scenarios. Typically, these activities form the key discussion points during the vision and due diligence phases. The M&A credit workflow could also originate during a corporate on boarding, which is common when an acquirer entity establishes a relationship with the bank for ease of business due to fact that the other entity already has a working relationship with the bank.

The integration phase involves the integration of the underlying systems to build the resulting entities as per the required end state. The details of the transfer of entities and credit allocation issues are hammered out and the external systems and processes are informed about the successful transition. After the transfer, the system should seamlessly handle the day-to-day credit transactions and workflows on the resulting entity within the boundaries of policies, regulations, and business requirements.



New Controlled Entity Structure with transition of credit balances.

Solutions & Services to Support M&A – Entity Structures and their Credit

Successfully transitioning the corporate entities to the required structure during and after an M&A implementation requires banks to have IT solutions and services that can handle the integration. Identifying the right systems can be tricky as technology vendors typically do not develop credit solutions specifically designed to assist with specific M&A

integration scenarios like pre (analysis, migration) and post-merger workflows.

Services that support end-to-end entity structure migration including its credit landscape and other aspects of pre- and post-merger workflows are critical components of an M&A credit solution. The credit landscape typically includes the credit balances of all the participating entities – allotted and consumed credits, earmarked credits, underlying credit hierarchies, past and historical credit data and workflows, and linked assets that underpin credit lines. Thus, banks need a credit solution that not only supports the M&A workflows out of the box but also factors for issues that can crop up during actual implementation. This not only avoids the related confusion post-merger, but also ensures smooth day-to-day credit operations and workflows.

The Right platform to handle credit complexity

Mergers and acquisitions are key activities in business. Corporate banks that usually manage the banking requirements for these activities should invest in credit applications that support the end-to-end business workflows. While most corporate businesses undergo a merger or acquisition only occasionally, when they do, it helps to have a banking partner who can help streamline the complex process.

Oracle offers a flexible end-to-end credit solution that enables banks to streamline M&A credit workflows. The configurable workflow capability supports multiple M&A scenarios including pre- and post-merger structure of corporate entities, transfer of their credit balances, and bulk transition capabilities. This helps banks to improve overall efficiency of their credit department thereby enabling them to offer a higher quality of service to their corporate customers.

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Source:

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