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„ CROSS-BORDER ACQUISITIONS IN TOBACCO INDUSTRY: THE CASE OF CROATIA “

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Finally, I wish that this thesis will highlight cross border acquisitions in the tobacco industry and especially the case in Croatia from 2015.

Vienna, 2016 Manuel DAMJANOVIC

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ABSTRACT

One of the most important transactions in global tobacco industry in 2015 - acquisition of leading company in Croatian tobacco industry Tvornica duhana Rovinj (TDR) by one of the leading companies in tobacco industry in the world British American Tobacco (BAT) for 505 million EUR in cash – was analyzed in this thesis. Besides, theoretical background on merges and acquisitions, characteristics of cross-border acquisitions and strategic analysis of global tobacco industry was presented in this thesis. All the research objectives were accomplished and it was concluded that that changes in TDR‘s profitability were caused by external factors (strong international competition, changing legislative framework, etc.), and that sell off of TDR was prudent strategic decision for its shareholders instead of further internal developing of tobacco business. By using comparable transactions method value of TDR's equity based on comparable multiples and performance indicators from 2007 was estimated, and it was found that shareholders of TDR would be better off if TDR was acquired at the begging of 2008 instead in 2015. TDR could thrived within global tobacco industry only if it perused M&A strategy like leading industry players.

Key words: cross-border acquisitions, global tobacco industry, Croatian tobacco industry, internalization.

ABSTRAKT

Eines der wichtigsten Transaktionen in der globalen Tabakindustrie im Jahr 2015 wurde in dieser Arbeit analysiert. Es geht um den Erwerb und die Übernahme eines in der kroatischen Tabakindustrie führenden Unternehmen namens "Tvornica Duhana Rovinj (TDR)" durch die globale und einflussreiche "British American Tobacco (BAT)" für 505 Millionen Euro. Darüber hinaus wurde in dieser Arbeit der theoretische Hintergrund der Zusammenschlüsse und Akquisitionen, die Merkmale der grenzüberschreitenden Akquisitionen und die strategische Analyse der globalen Tabakindustrie dargestellt. Alle Forschungsziele wurden erreicht.

Schlussendlich kam dabei heraus, dass Veränderungen der TDR- Rentabilität durch externe Faktoren (starker internationaler Wettbewerb, veränderte gesetzliche Rahmenbedingungen usw.) verursacht wurden und dass der Verkauf der TDR eine strategische Entscheidung war anstelle einer internen Weiterentwicklung des Tabakgeschäfts.

Durch den Einsatz vergleichbarer Transaktionen wurde der Wert des Eigenkapitals der TDR auf Basis vergleichbarer Multiplikatoren und Leistungsindikatoren aus dem Jahr 2007 geschätzt. Des Weiteren wurde festgestellt, dass die Aktionäre der TDR besser abgeschnitten hätten, wäre die TDR zu Beginn des Jahres 2008 statt im Jahre 2015 erworben worden.

Die TDR konnte sich den wirtschaftlichen Erfolg in der Tabakindustrie sichern, hätte sie sich die M&A Stragien der führenden Unternehmen nahegelegt.

Schlüsselwörter: Grenzüberschreitende Akquisitionen, globale Tabakindustrie, kroatische Tabakindustrie, Internalisierung.

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1. INTRODUCTION

Execution of corporate growth strategy has been regularly conducted through mergers and acquisitions (M&A). "Growth through mergers and acquisitions provides access to new markets and resources, and success or failure of mergers and acquisitions is of great importance not only for companies included that in that process, but also for all participants of that process, and for the whole economy."[1] Technological development and globalization have vastly contributed to the popularity of M&A and cross-border M&A. The analysis in this thesis is narrowed to cross-border M&A as a mode of entry/diversification in a foreign market. Theoretical backgrounds for this research were transaction cost economics and ownership-location-internalization framework.[2] Additionally, when it comes to theoretical foundations for cross-border mergers and acquisitions research four approaches can be derived from recent literature: event study approach, accounting approach, survey based approach and case study.[3]

Event study methodology is based on the abnormal returns which are the result of difference between the realized return and the expected return of company's industry in the event that transaction did not happen and this was developed by Fama, Fisher, Jensen and Roll.[4] Research about the impact of cross-border mergers and acquisitions on shareholder wealth is mainly based on short-term effects, and is built on the assumption that the announcement of potential transactions provides new information on the market upon which the investors' expectations are built and consequently reflected in the stock price, therefore the event study methodology is frequently used in this category of research on cross-border mergers and acquisitions.[5]

Also, very common methodology in measuring the profitability of cross-border mergers and acquisitions is the accounting approach. This approach focuses on the business performance of the company before and after cross-border mergers and acquisitions and focuses on

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[1] Filipović, D., Sapunar, I., Sapunar, G. (2011.), Overview of crucial variables for M&A success, *Annals of DAAAM & Proceedings of the 22nd International DAAAM Symposium*, 22(1): 807.
[2] Dunning, J., Lundan, S. (2008.), *Multinational Enterprises and the Global Economy*, Second edition, Edward Elgar Publishing, Cheltenham, UK, pp. 96-107.
[3] Burner, F. R. (2001) Does M&A Pay? A Survey of Evidence for the Decision-Maker, *Journal of Applied Finance*, 12(1): 49-50.
[4] Fama, E. F., Fisher, L., Jensen, M. C., Roll, R. (1969.), The Adjustment of Stock Prices to New Information, *International Economic Review*, 10(1): 1-21.
[5] DePamphilis, D. M. (2014.), *Mergers, Acquisitions, and Other Restructuring Activities*, Seventh Edition, Academic Press, San Diego, pp. 28.

identifying the change in performances after the transactions. Marynova and Renneboog identified that comparison of company's performance before and after the transaction by using accounting indicators is generally accepted for business performance analysis.[6]

Surveys and interviews with the corporate core stakeholders are also used as a methodology in measuring the success of cross-border mergers and acquisitions. These methodologies provide answers to questions regarding the profitability of the acquired companies if acquired company stays as independent organizational unit and/or achieving anticipated synergies if acquired company has been incorporated in the business system of the bidder.[7]

The case study methodology explores a single transaction or a few transactions, and the detailed analysis leads to conclusions about the acquisition success.[8] As widely used research method in field of M&A, case study methodology is used in this thesis to analyze one of the most important transactions in global tobacco industry in 2015 – acquisition of leading company in Croatian tobacco industry Tvornica duhana Rovinj (TDR) by one of the leading companies in tobacco industry in the world British American Tobacco (BAT) for 505 million EUR in cash.

In order to examine most important aspects of TDR's acquisition by BAT following objectives were set:

- to analyze M&A trends in global tobacco industry,
- to analyze leading tobacco companies in the world,
- to assess profitability and performance of TDR prior transaction,
- to assess whether acquisition of TDR was good decision for its shareholders,
- to analyze could owners of TDR continue to develop organically,
- to research whether TDR's shareholders were satisfied with the price of the transaction.

Based on the objectives in this research following hypothesis were set:

[6] Marynova, M., Renneboog, L. A. (2008.), A century of corporate takeovers: What have we learned and where do we stand?, *Journal of Banking and Finance*, 32(10): 2153.
[7] Burner, F. R. (2001) Does M&A Pay? A Survey of Evidence for the Decision-Maker, *Journal of Applied Finance*, 12(1): 51.
[8] Schoenberg, R. (2006.), Measuring the Performance of Corporate Acquisitions: An Empirical Comparison of Alternative Metrics, *British Journal of Management*, 17(4): 364.

H1: Changes in TDR‘s profitability were caused by external factors (strong international competition and changing legislative framework, etc.)
H2: Sell off of TDR was prudent strategic decision for its shareholders instead of further internal developing of tobacco business
H3: Shareholders of TDR would be better off if TDR was acquired at the beginning of 2008 instead in 2015.

Since Republic of Croatia entered European Union on July 1st, 2013 in order to test first hypothesis it is necessary to examine impact of external factors, mainly foreign competition and new legislative framework, on TDR's profitability. Afterwards, it is important to test the dilemma which many small size companies (compared with global industry leaders) face at certain stage of their life cycle – to develop their core business by themselves or to become acquisition target. Third hypothesis refers to the timing of TDR's acquisition, and tries to provide answer on weather TDR's shareholders would be better off if TDR was acquired after its peak in business performance.

After the introduction, in second part of this thesis, theoretical background on merges and acquisitions is presented. The chapter incorporates definitions of merges and acquisitions, theoretical approaches to merges and acquisitions, historical waves of mergers and acquisitions and mergers and acquisitions’ process. Theoretical approaches to merges and acquisitions include industrial organization approach, managerial approach, financial and organisational approach. Third chapter focuses on distinctiveness of cross-border mergers and acquisitions. Firstly, internationalization process and drivers are described, and afterwards obstacles ad motives for cross-border mergers and acquisitions. That chapter ends with assessment of empirical evidence on cross-border mergers and acquisitions success. Fourth chapter is dedicated to strategic analysis of global tobacco industry. The strategic analysis includes competitive forces analysis of global tobacco industry, analysis of leading corporations in global tobacco industry and detail analysis of cross-border mergers and acquisitions in the industry. The empirical research of cross-border acquisition in tobacco industry in Croatia is covered in fifth chapter along with analysis of tobacco industry in Croatia and analysis of TDR's acquisition by BAT. The master thesis ends with recommendations, limitations and suggestions for future research.

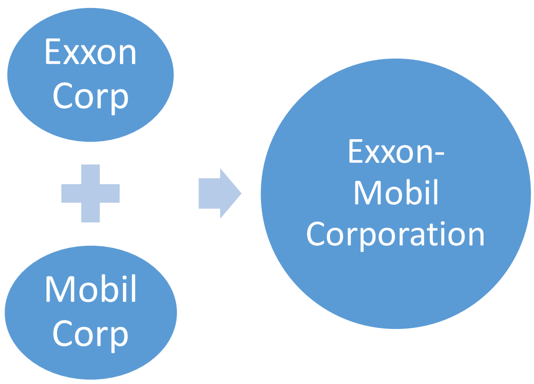
2. THEORETICAL BACKGROUND ON MERGERS AND ACQUISITIONS

In this chapter M&A terminology and theoretical approaches to mergers and acquisitions will be determined. Afterwards, historical development of mergers and acquisitions as well as M&A process will be explained.

2.1. Definitions of mergers and acquisitions

"Acquisition occurs when one company takes a controlling ownership interest in another company, a legal subsidiary of another company, or selected assets of another company such as manufacturing facility. An acquisition may involve the purchase of another company's assets or stock with the acquired company continuing to exist as legally owned subsidiary."[9] Term merger is usually used to describe a situation in which after the combination of two companies only one company survives. Term merger also refers to "a combination of two companies that are of similar sizes and where both companies cease to exist following the deal and an entirely new company is created".[10] For example, in 1999 due to persistently low oil prices pressuring the industry Exxon Corp and Mobil Corp merged and created energy superpower Exxon-Mobil Corporation (figure 1). Other well know examples of companies created through mergers include pharmaceutical firm GlaxoSmithKline and oil company Royal Dutch Shell.[11]

Figure 2.1. Companies merge and create new entity



Source: Author.

[9] DePamphilis, D. M. (2010.), *Mergers, Acquisitions, and Other Restructuring Activities,* Fifth edition, Academic Press, San Diego, pp. 20.
[10] Gaughan, P. A. (2005.), *Mergers: what can go wrong and how to prevent it*, John Wiley & Sons, Hoboken, New Jersey, pp. 3.
[11] Gaughan, P. A. (2013.), *Maximizing Corporate Value through Mergers and Acquisitions: A Strategic Growth Guide,* John Wiley & Sons, Hoboken, New Jersey, pp. 5.

M&A literature often uses terms takeovers and acquisitions as synonyms, but usually takeover is used to reference a hostile activity, while acquisition is frequently used to describe more friendly activity, or used in combination with the word merger, where both companies are willing to join together.[12]

Friendly acquisition is one in which target's management does not resist to the acquisition and thinks that acquisition is sound choice for all target's shareholders. In that situation target's management recommends to its shareholders to sell their shares to the acquirer. Acquirer is expected to offer higher price for a share then the current market price to target's shareholders. Difference between current market price and offered price for one target's share refers to acquisition premium. During period of 30 years ending in 2011, U.S. acquisition premium averaged 43%, reaching its peak of 63% in 2003, and low of 31% in 2007.[13] Acquisition premium reflects perceived value of obtaining a controlling interest in the target, the value of expected synergies, resulting from combining two firms. The offer to buy shares in another firm is called tender offer. While tender offers are used in number of circumstances, they most often result from friendly negotiations (negotiated tender offers) between the acquirer's and target's boards. Self-tender offers are used when company wants to repurchase it stock. Those that are unwanted by the target's board are referred as hostile tender offers. "An unfriendly or hostile takeover occurs when the initial approach was unsolicited, the target was not seeking for a merger at that time, the approach was contested by the target's management, and the control changed hands (i.e. usually requiring the purchase of more than half of target's voting common stock)."[14] Acquirer may avoid target's management by buying shares in a public stock exchange and buy them directly from shareholders.[15] Friendly acquisitions are often closed at lower purchase price than hostile takeovers because hostile takeover attempts can attract new bidders which otherwise would not be interested in the target. Acquirers also prefer friendly acquisitions because the post-acquisition integration process is accomplished much better when both parties cooperate fully.[16] In case of successful hostile takeover, target's

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[12] http://www.investopedia.com/terms/a/acquisition.asp (6.7.2016.).
[13] DePamphilis, D. M. (2014.), *Mergers, Acquisitions, and Other Restructuring Activities,* Seventh edition, Academic Press, San Diego, pp. 18.
[14] DePamphilis, D. M. (2010.), *Mergers, Acquisitions, and Other Restructuring Activities,* Fifth edition, Academic Press, San Diego, pp. 21.
[15] DePamphilis, D. M. (2010.), *Mergers, Acquisitions, and Other Restructuring Activities,* Fifth edition, Academic Press, San Diego, pp. 21.
[16] DePamphilis, D. M. (2008.), *Mergers, Acquisitions, and Other Restructuring Activities,* Fourth edition, Academic Press, San Diego, pp. 8.

management usually gets replaced with new management while after friendly acquisitions target's management continues to manage the company.[17]

Besides cash and shares, acquisitions can be financed with huge amounts of debt. Acquisitions that are primarily financed by debt are called levered buyout transactions – LBO. During the LBO, acquirer finances transaction with a combination of debt and equity. After transaction is realized debt-equity ratio is significantly changed, and it is much higher than before the transaction. Target's assets are used as debt collateral, and borrowed funds are paid back out of target's cash flow. LBOs were introduced by private equity funds, and most prominent fund, often mentioned in M&A literature is called Kohlberg Kravis Roberts & Co (KKR).[18] "LBO is also referred to a transaction in which a public company is bought using debt and then goes private."[19] The largest LBO for many years was that of RJR Nabisco in 1988 for 24,8 billion $. RJR Nabisco was bought by KKR.[20] LBOs are sometimes used when incumbent management decides to acquire the target itself. That type of leveraged buyout is called management buyout (MBO). Employees can also acquire their company by using debt in the transaction called employee buyout.[21]

Mergers and acquisitions could have national and international character. Merger or acquisition within one country's boundaries e.i. transaction between two or more companies from the same county is defined as a domestic merger of acquisition. Transactions that occur outside country's borders e.i. transactions which include companies from at least two countries are characterized as cross-border mergers or acquisitions. Cross-border acquisitions also include transatlantic acquisitions. Transatlantic acquisition refers to a transaction in which at least one company from U.S., Canada, Central America or Caribbean acquires company from Europe and vice versa.[22]

M&A transactions can also be seen as vertical or horizontal ones. By using vertical acquisitions companies penetrate to new industries in order to increase its long-term

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[17] Tipurić, D. ed. (2008.), *Korporativno upravljanje*, Sinergija, Zagreb, pp. 302-303.
[18] Filipović, D. (2012.), *Izazovi integracijskih procesa: rast poduzeća putem spajanja, preuzimanja i strateških saveza*, Sinergija, Zagreb, pp. 22.
[19] Gaughan, P. A. (2005) *Mergers: what can go wrong and how to prevent it*, John Wiley & Sons, Hoboken, New Jersey, pp. 20.
[20] Gaughan, P. A. (2013.), *Maximizing Corporate Value through Mergers and Acquisitions: A Strategic Growth Guide,* John Wiley & Sons, Hoboken, New Jersey, pp. 11.
[21] Tipurić, D. (2004.), ESOP i hrvatsko poduzeće, Sinergija, Zagreb, pp. 2.
[22] Available at: www.mergermarket.com/home/glossary.asp (8.7.2016.)

profitability. Vertical acquisitions can be directed forward or backward. Forward acquisitions, taking into consideration value chain, refer to transactions in which company acquires targets that use, distribute or sell its products while backward acquisitions refer to transactions in which company acquires targets that produce inputs for its production. Through vertical acquisitions companies create entering barriers for competitors, and enable themselves to earn higher profits that would not be able to achieve without those barriers.[23] Horizontal mergers and acquisitions are those that occur within the same industry, and they should be as a way acquirer can increase its profitability by merging or acquiring target's assets or other resources like human capital and know-how.[24]

2.2. Theoretical approaches to the mergers and acquisitions

Different theoretical approaches show that M&A is a process subject to a variety of often conflicting forces, and the outcome of mergers and acquisitions is generally determined by the interplay of the external and firm-specific forces. Therefore, in this part of the thesis various theoretical perspectives will be elaborated in identifying the key challenges for creating value through mergers and acquisitions.[25] Since a modern corporation, especially a medium or large-sized firm, tends to be a multi-product firm, this model is assumed in the following discussion since it allows incorporating economies of scope, transaction costs, diversification and some managerial motives for mergers and acquisitions and other elements as being relevant for this discussion.

The economic perspective on mergers and acquisitions focuses on their impact on the various costs faced by the firms and on their market power. Therefore firms merge in order to gain competitive advantage over their rivals through cost reduction and increased market power. Where a firm is a multi-product firm selling a number of related or unrelated products, cost reduction may be achieved through both economy of scale and economy of scope. An economy of scale refers to the cost reduction in producing a product from increasing the scale

[23] Hill, C. W. L., Jones, G. R. (2008.), *Essentials of Strategic Management*, Houghton Miffin, Boston, pp. 170.
[24] Filipović, D. (2012.), *Izazovi integracijskih procesa: rast poduzeća putem spajanja, preuzimanja i strateških saveza*, Sinergija, Zagreb, pp. 24.
[25] Sudarsanam, S. (2010.), *Creating Value from Mergers and Acquisitions*, Second edition, Prentice Hall International Limited, London, pp. 80.

of the production in a given period.[26] Since production costs may have a fixed component that is constant to production volume, like rents, administrative costs, so the average cost of production falls when these fixed costs are spread over a larger volume. But, scale economies may also be limited for several reasons. For example, once the firm passes the minimum efficient scale there are no further efficiency gains, or when the firm becomes very large, organizational control problems may cause diseconomies of scale.[27]

A firm can reduce the costs of producing the same volume of output in successive production period through the learning process. While scale economy is concerned with the scale of output in a single period, learning economy is concerned with cumulative volume of the same product over several periods. Mergers may offer sharing the best practices based on accumulated knowledge and experience of the staff of the merging companies, but the case for learning economy is much weaker than for scale economy as a rationale for mergers.[28] Economy of scope exists when the total costs of producing and selling several products by the multi-product firm is less than the sum of costs of producing and selling the same products by individual firms specialized in each of those products.[29]

Scope economy may also be manifested in the form of increased revenue and profits rather than unit cost reduction of the individual product. It refers to effective use of existing common resources and capabilities that creates added value through increased volume and sales revenue, rather than through efficiency. In theory, scale, learning and scope economies are function of the size of the firm, and large firms have advantage over small firms. And since mergers are a quick way to increase firm's size, firms may resort to these transactions to exploit these economies.[30] The economic perspective of mergers and acquisitions focuses also on transaction cost economics and vertical integration. Firms choose between the make and buy alternatives by evaluating transactional costs of dealing with independent parties in the market or internal organization. Firms can undertake mergers and acquisitions to bring about

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[26] Economies of scale are one of the entry barriers in Porter's five forces model of competition. Porter, M. E. (1980.), *Competitive Strategy: Techniques for Analyzing Industries and Competitors*, The Free Press, New York, pp. 7.

[27] Minghzou, J., David, S. W., Murat, E. (2006.), Multiple unit auctions with economies and diseconomies of scale, *European Journal of Operational Research*, 174(2): 816-834.

[28] Sudarsanam, S. (2010.), *Creating Value from Mergers and Acquisitions*, Second edition, Prentice Hall International Limited, London, pp. 51-52.

[29] Porter, M. E. (1980.), *Competitive Strategy: Techniques for Analyzing Industries and Competitors*, The Free Press, New York, pp. 8.

[30] Sudarsanam, S. (2010.), *Creating Value from Mergers and Acquisitions*, Second edition, Prentice Hall International Limited, London, pp. 52.

vertical integration of the neighboring stages from the inputs through production to retailing to the costumers.[31]

Strategic perspective includes two dominant paradigms: traditional structure-conduct-performance paradigm (SCP model) and resource-based view (RBV). In the SCP model industry structure plays a central role, and shapes firm conduct and determines firm as well as average industry profit performance. Porter defines industry competitive structure by the interaction of these five forces: current competitive rivalry, threat of new entrants, relative bargaining power of the buyers of firm's output, relative bargaining power of the seller of firm's inputs, and the threat of substitutes.[32] These five forces determine the average profitability of firms in the industry and hence its attractiveness.[33] They are not of equal strength within the same industry or across industries. An assessment of market attractiveness depends in turn upon an assessment of the strength of these factors. The weaker the threat of the five forces, consequently market is more attractive.[34]

Table 2.1. Competitive force level and industry attractiveness

Threat to firm from:	**Level of threat makes industry**		
	Very unattractive	*Possibly attractive*	*Very attractive*
Current rivals	High	High	Low
Substitutes	High	Low	Low
New entrants	High	Low	Low
Buyers	High	High	Low
Sellers	High	High	Low
Risk to profitability	High	Indeterminate, depends on relative force levels	Low

Source: Sudarsanam, S. (2010.), *Creating Value from Mergers and Acquisitions*, Second edition, Prentice Hall International Limited, London, pp. 56.

[31] Hill, C. W. L., Jones, G. R. (2008.), *Essentials of Strategic Management*, Houghton Mifflin Company, Boston, pp. 169.
[32] Porter's work drew on industrial organization (IO) economics. Porter, M. (1979.), How Competitive Forces Shape Strategy, *Harvard Business Review*, 57(March/April): 137-145.
[33] Porter, M. (1998.), *Competitive Advantage: Creating and Sustaining Superior Performance*, The Free Press, New York.
[34] Buble, M. (2010.), *Strateški menadžment*, Sinergija, Zagreb.

Firms may attempt to change the five forces configuration through mergers and acquisitions.[35] For example, if profitability is depressed because of the threat of new entrants, a merger that generates substantial scale economies to move the firm beyond the minimum efficient scale of production may raise the entry barrier to new entrants, which will operate below the minimum efficient scale threshold. A merger that gives privileged access to suppliers or distribution channels reduces current rivalry. Of course, the rivals may emulate the first firm and carry out copycat mergers to achieve the same scale economies or gain similar access.[36]

Second paradigm in strategic perspective is resource-based view (RBV) which suggests that firms should seek for their competitive advantage internally, based on their resources and capabilities.[37] Resources and capabilities are competitive if they have the following characteristics: valuable, rare, inimitable, and be exploited by organization.[38]

While firms can develop their resources and capabilities to gain competitive advantage where the gap between their current endowment and the desired profile to accomplish their competitive goals is wide, firms may follow the merger and acquisition strategy to fill this gap. Acquisition of resources through M&A may be easier than acquisition of capabilities, because of the latter's embedded nature. Thus capability acquisition and integration into a more harmonious whole within the merged entity pose particularly challenging organizational problem.[39] It is important to stress that for the acquisition's success it is important to understand the new set of resources and capabilities in the combined firm and it is important to create a new model to leverage them.

Financial perspective on mergers and acquisitions "focuses on the inside of the firm: internal systems, decision processes, decision-makers' motivation and their behaviors… financial theory considers merger decisions of firms within the framework of the conflict of interests

[35] Sudarsanam, S. (2010.), *Creating Value from Mergers and Acquisitions*, Second edition, Prentice Hall International Limited, London, pp. 57.
[36] Sudarsanam, S. (2010.), *Creating Value from Mergers and Acquisitions*, Second edition, Prentice Hall International Limited, London, pp. 57.
[37] Huff, A. S., Floyd, S. W., Sherman, H. D., Terjesen, S. (2009) Strategic Management: logic and action, John Wiley & Sons, Honoken, NJ, pp. 328.
[38] Barney, J. (1995.), Looking Inside for Competitive Advantage, *Academy of Management Executive*, 9(4): 49-61.
[39] Sudarsanam, S. (2010.), *Creating Value from Mergers and Acquisitions*, Second edition, Prentice Hall International Limited, London, pp. 66.

among various financial claim holders of those firms".[40] This framework rests on the following elements:

- shareholder wealth maximization as the principal goal of corporate investment and financing decision;
- the agency model of the firm as a nexus of contracts, and the characterization of managers as agents, agency costs and conflicts of interests between principals and agents;[41]
- deviation from the shareholder wealth maximization objective due to agency problems;[42]
- internal corporate governance constraints on managerial self-interest pursuit;
- external constraints imposed by activism of institutional and large block shareholders; and external constraints imposed by the market for corporate control.[43]

Managerial perspective is connected with agency theory. "Under this perspective managerial motives for mergers and acquisition are considered as crucial determinants of the incidence, rationale, type, deal structure and outcome of mergers. One of the important considerations for managers during mergers is the extent of their control loss."[44] When talking about M&As, managers may act to maximize their personal interests. They may accept lower premium offer if a bidder will provide them with high managerial position or provide them with a share in management control.[45] Behavioral perspectives on managerial motivations for mergers or the outcome of mergers include the hubris hypothesis developed by Richard Roll[46] and the risk

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[40] Sudarsanam, S. (2010.), *Creating Value from Mergers and Acquisitions*, Second edition, Prentice Hall International Limited, London, pp. 72.

[41] Agency theory defines relationship between principal and agent where principal delegates work to the agent. Leading goal of the agency theory is to develop optimal contract between principal and agent. Agent tries to maximize personal utility function thru fulfilling principal's goals and agent's commitment is result of rewards' value for fulfilling these goals. According to: Podrug, N., Filipović, D., Milić, S. (2010.), Critical overview of agency theory, *Annals of DAAAM for 2010 & Proceedings of the 21st International DAAAM Symposiums*, 21 (1): 1227.

[42] "Agency theory assumes that principal's wealth, per se, would not be maximized because agent and principal: (1) have different goals, (2) have different access to information (principal cannot monitor what agent does and know which information agent has), and (3) different propensity towards risk." According to: Podrug, N., Filipović, D., Milić, S. (2010.), Critical overview of agency theory, *Annals of DAAAM for 2010 & Proceedings of the 21st International DAAAM Symposiums*, 21 (1): 1227.

[43] Failure of internal governance activates an external control device, defined by Henry Manne as the market for corporate control. Mann, H. (1965.), Mergers and the market for corporate control, *Journal of Political Economy*, 73: 110-120.

[44] Sudarsanam, S. (2010.), *Creating Value from Mergers and Acquisitions*, Second edition, Prentice Hall International Limited, London, pp. 78.

[45] Sudarsanam, S. (2010.), *Creating Value from Mergers and Acquisitions*, Second edition, Prentice Hall International Limited, London, pp. 78.

[46] Roll, R. (1986.), The Hubris Hypothesis of Corporate Takeovers, *Journal of Business*, 59(2): 198-199.

diversification hypothesis put forward by Amihud and Lev[47]. Infected with hubris, acquiring company managers overestimate their capacity to create value out of acquisitions, and often overpay for them. Roll uses this argument to explain the failure of most acquisition to create value for acquirer shareholders.[48] Amihud and Lev emphasize that stock options increase the proportion of managerial capital invested in their own firm, which results in the increase of their exposure to firm-specific risk.[49] Therefore, they undertake diversifying acquisitions to minimize the volatility of the firm's earnings, thereby reducing the risk of bankruptcy and the risk to their own jobs and their investment in their firm. Managers' psychological biases like as hubris, over-optimism and overconfidence drive them to undertake high risk acquisitions or overpay for them, thereby increasing the chance of value destruction.[50]

Organizational perspective on mergers and acquisitions examines "the decision-making processes within a firm as being not entirely rational but subject to a wide variety of pressures and pulls of a political nature. Different actors within firm have different motives, goals and expectations regarding a merger."[51] Also, in the post-acquisition period, the organizational dynamics and human aspects define integration success. For example, DePamphilis argues that from organizational perspectives, differences in corporate culture are recognized as prevalent reasons for negative effects in mergers and acquisitions.[52]

M&A is also a learning process, since to leverage one another's resources and capabilities after a merger the merging firms must learn about each other's resources and capabilities and they can be leveraged to gain or create competitive advantage. The organizational learning perspective provides insights into this learning process, including what the barriers are to effective learning. This perspective also emphasizes M&A as a change process.[53]

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[47] Amihud, Y., Lev, B. (1981.), Risk reduction as managerial motive for conglomerate mergers, *Bell Journal of Economics*, 12(2): 605-617.
[48] Roll, R. (1986.), The Hubris Hypothesis of Corporate Takeovers, *Journal of Business*, 59(2): 198-199.
[49] Amihud, Y., Lev, B. (1981.), Risk reduction as managerial motive for conglomerate mergers, *Bell Journal of Economics*, 12(2): 605-617.
[50] Sudarsanam, S. (2010.), *Creating Value from Mergers and Acquisitions*, Second edition, Prentice Hall International Limited, London, pp. 78.
[51] Sudarsanam, S. (2010.), *Creating Value from Mergers and Acquisitions*, Second edition, Prentice Hall International Limited, London, pp. 79.
[52] DePamphilis, D. M. (2010.), *Mergers, Acquisitions, and Other Restructuring Activities,* Fifth edition, Academic Press, San Diego, pp. 227-231.
[53] Galpin, T. J., Robinson, D. E. (1997.), Merger integration: The ultimate change management challenge, *Mergers and Acquisitions*, 13(4): 24-28.

These alternative perspectives provide a much richer set of models than any single perspective, and may explain not only the rationale for corporate acquisition decisions but also the organizational context and the processes the conditions the decisions. The alternative approaches are not always mutually exclusive.

2.3. Historical waves of mergers and acquisitions

One of the striking aspects of mergers and acquisitions as a phenomenon is that they occur in burst interspersed with relative inactivity. This pattern is called wave pattern of mergers and acquisitions and has been observed in the United States of America with perhaps the longest history of mergers for over 100 years, in the UK from the early 1960s and, more recently, in continental Europe. What triggers these waves and why they subside are not fully understood, although alternative theories of mergers and acquisitions waves have been propounded and several possible contextual explanatory factors have been identified. Another, possibly related, aspect of phenomenon of merger waves is that mergers often happen in industry clusters. Different industries undergo abnormally intense merger activity at different times. This pattern points to some industry-specific factors that may trigger the clusters.[54]

M&A cluster in waves, and there are two explanations regarding this phenomena. One explanation relates to industry shocks such as from deregulation, the emergence of new distribution channels and technologies, sustained raise in commodity prices or substitute products.[55] Such events often cause firms to acquire either all of parts of other firms. The second argument is based on misevaluation and suggests that managers use overvalued stock to buy the assets of lower-valued firms. For M&As to cluster in waves, goes the argument, valuations of many firms must increase at the same time. Managers whose stocks are believed to be overvalued more concurrently to acquire firms whose stock prices are lesser valued.[56] For this theory to be correct, the method of payment would normally be stock. In fact, the empirical evidence shows that less stock is used to finance takeovers during merger waves.[57]

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[54] Sudarsanam, S. (2005.), *Creating Value from Mergers and Acquisitions*, Prentice Hall International Limited, London, pp. 14-15.
[55] DePamphilis, D. M. (2014.), *Mergers, Acquisitions, and Other Restructuring Activities*, Seventh Edition, Academic Press, San Diego, pp. 11.
[56] Shleifer, A., Vishny, R. W. (2003.), Stock market-driven acquisitions, *Journal of Financial Economics*, 70: 295-311.
[57] DePamphilis, D. M. (2014.), *Mergers, Acquisitions, and Other Restructuring Activities, Seventh Edition*, Academic Press, San Diego, pp. 11-12.

Academic literature identifies six periods of high M&A activity e. i. M&A waves which occurred in United States. Those waves occurred during early 1900s, the 1920s, the 1960s, the 1980s, the 1990s and in the period between 2003 and 2007.[58] First wave, which started at the end of 19th century in the United States of America, was labeled by economic expansion, different innovations in industrial processes and significant technological changes.[59] M&A activity reflected a drive for efficiency, lax enforcement of the Sherman Anti-Trust Act, migration and technology change.[60] This wave was also characterized with continuous consolidation of producers within industries, and therefore was described as horizontal wave by many researchers. Besides, George Stigler, a Nobel Prize winner, pointed out that companies were engaging in M&A processes in this wave order to create monopolies.[61] Due to horizontal consolidation, many companies disappeared and also many well-known corporations like GE, DuPont, American Can and American Tobacco were created during that wave. This wave ended around 1903-1904 because of the market crash and First World War.[62]

"M&A activity remained at a modest level until the late 1910s as a consequence of the First World War. The second takeover wave emerged in the late 1910s and continued through the 1920s. The second wave was considered as a move towards oligopolies because, by the end of the wave, industries were no longer dominated by one giant firm but by two or more corporations. Most of the mergers of the 1920s were between small companies left outside the monopolies created during the previous wave. By merging, these companies intended to achieve economies of scale and build strength to compete with the dominant firm in their industries."[63]

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[58] Gaughan, P. A. (2011.), *Mergers, acquisitions, and corporate restructuring,* Fifth Edition. John Wiley & Sons, Hoboken, NJ, pp. 35.

[59] Filipovic, D., Vrankic, I., Mihanovic, D. (2014.), Theoretical Overview of Microeconomic Aspects of Mergers and Acquisitions. *Proceedings of the 6th International Scientific Conference on Economic and Social Development and 3rd Eastern European ESD Conference – Business Continuity*, Vienna, pp. 453.

[60] DePamphilis, D. M. (2014.), Mergers, Acquisitions, and Other Restructuring Activities, Seventh Edition, Academic Press, San Diego, pp. 12.

[61] Filipovic, D., Vrankic, I., Mihanovic, D. (2014.), Theoretical Overview of Microeconomic Aspects of Mergers and Acquisitions. *Proceedings of the 6th International Scientific Conference on Economic and Social Development and 3rd Eastern European ESD Conference – Business Continuity*, Vienna, pp. 453.

[62] Sudarsanam, S. (2010.), *Creating Value from Mergers and Acquisitions*, Second edition, Prentice Hall International Limited, London, pp. 16-17.

[63] Filipovic, D., Vrankic, I., Mihanovic, D. (2014.), Theoretical Overview of Microeconomic Aspects of Mergers and Acquisitions. *Proceedings of the 6th International Scientific Conference on Economic and Social Development and 3rd Eastern European ESD Conference – Business Continuity*, Vienna, pp. 453; Marynova, M., Renneboog, L. (2008.), A century of corporate takeovers: What have we learned and where do we stand?, *Journal of Banking and Finance*, 32(10): 2151.

Second wave came along with stock market boom and economic expansion. Around 12,000 companies disappeared during this wave even though an impact on the industries' market structures was less dramatic than the first wave. This wave collapsed due to stock market collapse in 1929, and due to the worldwide depression in the following, many of the utility holding companies formed during this collapsed into bankruptcy.[64]

M&A activities decreased significantly after the Second World War. When third M&A wave started in 1950s it lasted almost for two decades. "The beginning of this wave in the US coincided with a tightening of the anti-trust regime in 1950. The main feature of this wave was a very high number of diversifying takeovers that led to the development of large conglomerates. Compared to first and second wave, mergers in this wave where not large and did not involve large acquirers and their motive was growth through unrelated diversification. The main feature of this wave was a very high number of diversifying takeovers that led to the development of large conglomerates. Through building conglomerates, companies planned to benefit from growth opportunities in new product markets unrelated to their primary business. This allowed them to boost value, decrease their earnings volatility, and to overcome imperfections in external capital markets. The third wave peaked in 1968 and collapsed in 1973, when the oil crisis pushed the world economy into a recession."[65]

"The start of the fourth wave coincided with changes in anti-trust policy, the deregulation of the financial services sector, the creation of new financial instruments and markets (e.g. the junk bond market), as well as technological progress in the electronics industry."[66] The revival of takeover activity and start of the fourth wave came along with recovery of markets in United States in the middle of the 1980s. "Many transactions were financed with large amounts of debt, and takeovers were often conducted by company's management trough management buyouts. Except of management buyouts, this wave was characterized the

[64] Sudarsanam, S. (2010.), *Creating Value from Mergers and Acquisitions*, Second edition, Prentice Hall International Limited, London, pp. 17-18.

[65] Marynova, M., Renneboog, L. (2008.), A century of corporate takeovers: What have we learned and where do we stand? *Journal of Banking and Finance*, 32(10): 2152; Filipovic, D., Vrankic, I., Mihanovic, D. (2014.), Theoretical Overview of Microeconomic Aspects of Mergers and Acquisitions. *Proceedings of the 6th International Scientific Conference on Economic and Social Development and 3rd Eastern European ESD Conference – Business Continuity*, Vienna, pp. 453-454.

[66] Marynova, M., Renneboog, L. (2008.), A century of corporate takeovers: What have we learned and where do we stand? *Journal of Banking and Finance*, 32(10): 2152-2153.

activity of private equity funds which conducted takeovers trough leverage buyouts."[67] Conglomerates created in previous wave become inefficient and they had to be restructured. The fourth M&A wave encompassed lots of transactions designed to force companies to specialize in certain operations or to downsize, and during that wave largest number of hostile takeover bids occurred in the United States of America.[68] Similarly to former waves, the stock market crash in 1987 ended this M&A wave.[69]

Increased economic globalization, technological innovation, deregulation and privatization, as well as the economic expansion influenced the start of the fifth takeover wave in 1993. This wave was important because of its size and geographical dispersion emphasizing its international character. The interesting thing was that the European M&A market was almost large as its US counterpart in the 1990s.[70] Besides, "a substantial proportion of M&As was cross-border transactions. Previously domestically-oriented companies resorted to takeovers abroad as a means to survive the tough international competition created by global markets. The dominance of industry-related (both horizontal and vertical) takeovers and the steady decline in the relative number of divestitures during the fifth wave suggests that the main takeover motive was growth to participate in globalized markets. Compared to the takeover wave of the 1980s, the 1990s wave counted fewer hostile bids in the UK and US. However, an unprecedented number of hostile takeovers were launched in Continental Europe."[71]

The fifth wave was also a period characterized by: shareholder value as a compelling imperative and the emergence of shareholder activism with traditional institutional investors benchmarking corporate investment and financing decisions against shareholder value creation; globalization of products, services and capital markets; new supranational trading blocs such as the Single Market of the European Union and NAFTA; government policy

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[67] Filipovic, D., Vrankic, I., Mihanovic, D. (2014.), Theoretical Overview of Microeconomic Aspects of Mergers and Acquisitions. *Proceedings of the 6th International Scientific Conference on Economic and Social Development and 3rd Eastern European ESD Conference – Business Continuity*, Vienna, pp. 454.

[68] Filipovic, D., Vrankic, I., Mihanovic, D. (2014.), Theoretical Overview of Microeconomic Aspects of Mergers and Acquisitions. *Proceedings of the 6th International Scientific Conference on Economic and Social Development and 3rd Eastern European ESD Conference – Business Continuity*, Vienna, pp. 454.

[69] Marynova, M., Renneboog, L. (2008.), A century of corporate takeovers: What have we learned and where do we stand? *Journal of Banking and Finance*, 32(10): 2152; Filipovic, D., Vrankic, I., Mihanovic, D. (2014.), Theoretical Overview of Microeconomic Aspects of Mergers and Acquisitions. *Proceedings of the 6th International Scientific Conference on Economic and Social Development and 3rd Eastern European ESD Conference – Business Continuity*, Vienna, pp. 454.

[70] Marynova, M., Renneboog, L. (2008.), A century of corporate takeovers: What have we learned and where do we stand? *Journal of Banking and Finance*, 32(10): 2152.

[71] Marynova, M., Renneboog, L. (2008.), A century of corporate takeovers: What have we learned and where do we stand? *Journal of Banking and Finance*, 32(10): 2152.

changes in the area of healthcare, deregulation of industries such as banking and utilities, and privatization of public sector enterprises; government policy changes in antitrust enforcement and defense procurement; restructuring of mature industries such as automobiles, baking and food; the convergence of technologies in voice, video and data transmission, leading to blurred boundaries among industries selling goods and services based on these technologies; consolidation of fragmented industries by financial buyers and strategic buyers; and continuation of the move towards core businesses or specialization started in 1980s.[72] The fifth wave ended after the burst of the dot-com bubble and the consequent stock market collapse in 2000. It is important to point out that terrorist attacks on September 11th 2001 had a significant impact on the decline of the M&A activity in the world.[73]

After the fifth wave and subsequent terrorist attacks on USA M&A activities picked up in 2003 and declined again in 2008 due to subprime mortgage crisis in the United States of America. "United States financial markets, especially from 2005 through 2007, were characterized by a proliferation of highly leveraged buyouts and complex securities collateralized by pools of debt and loan obligations of varying levels of risk. Much of financing of these deals, as well as mortgage-backed security issues, has taken the form of syndicated debt.[74] Lenders have an incentive to increase the volume of lending to generate fee income by accepting riskier loans. Once loans are sold to others, loan obligators are likely to reduce the monitoring of such loans. These practices, coupled with exceedingly low interest rates (which substantially underpriced risk) made possible by a word awash in liquidity and highly accommodative monetary policies, contributed to excessive lending and encouraged acquirers to overpay significantly for target firms. However, limited credit availability, as banks attended to rebuild their capital following substantial asset write-downs, not only affected the ability of private equity and hedge funds to finance new and refinance existing transactions but also limited the ability of other businesses to fund operations."[75]

The survey of the mergers waves around the world shows that while the early waves were influenced by conditions in the individual countries and by firms seeking to alter their

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[72] Sudarsanam, S. (2010.), *Creating Value from Mergers and Acquisitions, Second edition*, Prentice Hall International Limited, London, pp. 21.

[73] Filipović, D., Podrug, N., Bujanović, H. (2011.), Mergers and acquisition: the case of Croatia, *The 5th International Scientific Conference "Entrepreneurship and Macroeconomic Management: Reflections on the World in Turmoil"*, 1: 733-752.

[74] Syndicated debt is debt purchased by underwriters for resale to the investing public.

[75] DePamphilis, D. M. (2014.), *Mergers, Acquisitions, and Other Restructuring Activities, Seventh Edition*, Academic Press, San Diego, pp. 13-14.

competitive positions because of their domestic rivals, the waves of the 1980s, 1990 and 2000s were characterized by similar trends in different countries, by increasing globalization of product and capital markets, by similarities of approaches to government's role in industry and regulation and corporate governance, and by shareholder value as important determining factor in corporate decisions. The increasing importance of cross-border M&A also reflect the strategies of companies to cope with the institutional changes in the EU, such as the Single Market and the Eurozone with a single currency, as well as the need to complete globally for markets, technologies and capabilities. Thus corporate M&A strategies seem to have evolved in response to these environmental changes as well as to changes affecting individual industries. There are, however, different perspectives on the causes of merger waves.[76]

2.4. Mergers and acquisitions' process

In order to increase a possibility of success in M&A transactions it is necessary to point a special focus on M&A process. This process can usually be viewed through planning and implementation stage. The planning stage is comprised of developing business and acquisition plans while implementation stage includes search, screening, contacting the target, negotiation, integration planning, closing, and evaluation activities.[77]

M&A process should be seen as a series of activities reaching its peak in the transfer of ownership from seller to buyer. A planning based acquisition process starts with business plan and also acquisition or merger plan. The business plan explains a mission or vision of the company and a business strategy for realizing mission for all company's stakeholders. The merger or acquisition's plan represents implementation of business strategy and describes in detail the motivation for M&A and how and when it will be achieved. Therefore, the first phase of M&A process involves building a business plan. External analysis, in order to determine where and how to compete (e. i. which industry or market; how company can most effectively compete in chosen markets) is first activity of well-developed business plan. This is followed by the internal analysis of company's strengths and weaknesses compared to its

[76] Sudarsanam, S. (2010.), Creating Value from Mergers and Acquisitions, Second edition, Prentice Hall International Limited, London, pp. 31.
[77] DePamphilis, D. M. (2014.), Mergers, Acquisitions, and Other Restructuring Activities, Seventh Edition, Academic Press, San Diego, pp. 117.

competition. External and internal analysis is usually conducted using SWOT analysis because it determines strengths, weaknesses, opportunities, and threats of business.[78]

Afterwards, based on the external analysis, company has to determine mission statement that points out what is the main purpose of the company, and how will company compete. Next step in formulation of business plan is setting of objectives as well as quantitative measures of financial and non-financial performance. After completing all previously mentioned steps, the company is ready to select a business strategy likely to achieve the objectives in accepted period. In general terms, business strategy defines how the business intends to compete (e. g. through cost leadership, focus or differentiation). Selection the implementation strategy is next step in formulation of the business plan. Implementation strategy should articulate how to implement a business strategy from among a range of reasonable options. Afterwards, functional strategy should be developed in order to define roles and responsibilities as well as to allocate resources to the most important functional areas which should support overall business strategy. Establishing the strategic controls to oversee current performance, implementing incentives and taking corrective actions if necessary is final step in developing a business plan.[79]

When the company decides to execute its business strategy thought acquisition, it will need an acquisition plan. “The acquisition plan is a specific type of implementation strategy focusing on tactical or short-term issues rather than strategic or longer-term issues. Management objectives, a resource assessment, a market analysis, senior management's guidance regarding the acquisition process, timetable, and the individual responsible for making it all happen are included in acquisition plan. High-performing manager should be appointed to develop acquisition plan. Senior management should, early in the process, appoint “deal owner” to this full or part time position. For example, it can be someone in the company's business development unit or any other manager with substantial deal-making experience. That individual should be responsible for the operation and integration of the target. The first steps

[78] DePamphilis, D. M. (2014.), *Mergers, Acquisitions, and Other Restructuring Activities*, Seventh Edition, Academic Press, San Diego, pp. 119-120.
[79] DePamphilis, D. M. (2014.), *Mergers, Acquisitions, and Other Restructuring Activities*, Seventh Edition, Academic Press, San Diego, pp. 119-133.

in the acquisition planning process are undertaken prior to selection of the target and refer to documenting the necessary plan elements before the search for a target can begin."[80]

"The search for the target begins with establishing a small number of primary selection criteria. Those criteria usually include industry and size of the transaction. Transaction size is usually defined as the maximum price an acquirer is willing to pay for target."[81] It may also be appropriate to limit the search to a specific geographical area. Targets could be searched through specialized databases, investment banks, brokers or private equity companies. Additionally, finding reliable information about privately owned firms is a major problem since specialized databases can offer only fragmentary data. The screening process can be considered as refinement of the initial search process. Potential targets are reduced using primarily criteria that was set, and additional criteria, like market segment, product line, profitability, degree of leverage, market share and cultural capability could be set in order to select appropriate target. Using both primarily and secondary criteria for target selection allows the acquisition process to move to next phase which refers to first contact. The characteristics of the target, especially size and weather target is a publically or privately held, determine how initial contact is made. Acquirer's time frame for completing a transaction is also very important for developing personal relationships with sellers especially if target is privately held company. Personal relationships have to be formed only at highest levels within privately held companies. When the target is public company personal relationships can go only so far in order to get the best price for its shareholders. If time is critical factor, acquirers will not have a possibility to develop personal relations with the seller, and therefore intermediaries on highest levels will be used. After the first contacts are established, parties in M&A transaction negotiate a confidentiality agreement, a term sheet, and a letter of intent early in the process.[82]

The most complex aspect of acquisition process is often following phase – negotiation. In this phase actual purchase price of the target is determined, and that price is often different from initial valuation of the target. "The negotiation phase is comprised of iterative activities that may begin at different times but tend to overlap. Due diligence starts as soon as target is

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[80] DePamphilis, D. M. (2014.), *Mergers, Acquisitions, and Other Restructuring Activities*, Seventh Edition, Academic Press, San Diego, pp. 135-136.
[81] DePamphilis, D. M. (2014.), *Mergers, Acquisitions, and Other Restructuring Activities*, Seventh Edition, Academic Press, San Diego, pp. 151.
[82] DePamphilis, D. M. (2014.), *Mergers, Acquisitions, and Other Restructuring Activities*, Seventh Edition, Academic Press, San Diego, pp. 154-158.

willing to permit it. Another activity is refining the preliminary valuation based on new data available due to due diligence, enabling acquirer to understand the target's value better. Deal structuring is a third activity, and involves meeting the needs of both parties by addressing issues of risks and reward. Final activity refers to financial plan which provides reality check for the buyer by defining the maximum amount the buyer can expect to finance and pay for the target."[83]

Due diligence is seen as one of the most important parts of acquisition process. It is a process of examination and assessment of the target by acquirer in which acquirer is trying to confirm that it is buying what it wants to buy. Due diligence also refers to business and financial examination as well as development perspective of the target. Well performed due diligence includes verification of target's assets and liabilities, identification and quantification of risks, protections from those risks and identification of potential synergies.[84] In comparison with traditional way of conducting due diligence which is oriented on closing the deal as well as financial and legal aspects of the transaction, contemporary way of conducting due diligence before the transaction has to enable better implementation of planned activities after closing a deal, and also isolation of risks before closing the deal.[85] Most important fields of due diligence encompass financial, legal and commercial field even though examination can be also focused on human resources, management, environment, production, intellectual property and informatics.[86] In practice, previously mentioned examination fields of due diligence are usually interconnected. Sometimes, human resources and intellectual property are examined within the legal due diligence, while informatics and production can be examined within financial due diligence.[87]

Information from due diligence has to be used to refine valuation e.i. to update preliminary target valuation based on new information. In general terms, target can be evaluated using discounted cash flow methods or by using relative valuation models. "Discounted cash flow valuation relates the value of an asset to the present value of expected future cash flows of asset, and relative valuation estimates value of an asset by looking at the pricing of

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[83] DePamphilis, D. M. (2014.), *Mergers, Acquisitions, and Other Restructuring Activities*, Seventh Edition, Academic Press, San Diego, pp. 159.
[84] Buble, M., et. al. (2010.), *Due diligence i procjena vrijednosti poduzeća*, Sarajevo, Kemigrafika, pp. 198.
[85] McGrady, S. (2005) Extending Due Diligence to Improve Mergers and Acquisitions, *Bank Accounting and Finance*, 18(4), pp. 17-49.
[86] Harding, D., Rouse, T. (2007.), Human Due Diligence, *Harvard Business Review*, 85(4), pp. 124-131.
[87] DeLong, G. (2003.), Does Long-Term Performance of Mergers and Acqusitions Match Expectations? Evidence from the US Banking Industry, *Financial Management*, 32(2), pp. 5-26.

comparable assets relative to a common variables like earnings, cash flow, book value, or sales."[88] Discounted cash flow valuation approach is very sensitive to estimated growth rates (e.g. dividend, earnings, cash flows or sales) which are used in specific valuation models. The most important thing in valuation process is that those variables have to be estimated. That implies that managers, who are decision makers when it comes to closing the deal, will arrive at different target values using same valuation methods. In order for acquisition to be successful it is extremely important that acquirer does not over pay the target, and that will not happen if acquirer's management makes real estimates of key valuation inputs. When using discounted cash flow methods it is also important to make adequate estimation of discount rate.[89] If target is operating in the industry characterized by permanent changes and unstable environment, discount rate has to reflect that operating risk, and therefore the discount rate has to be much higher than discount rate for targets which operate in stable environment. Discount rate strongly impacts target valuation because higher discount rate reduces value of discounted cash flows, and thus the target's value.[90]

In comparison with discounted cash flow models relative or multiple-based valuation models is extremely popular among M&A professionals, and will be used in this thesis to evaluate TDR. In relative valuation an asset is appraised by comparison against similar assets whose market values are known. If the target asset is a company, the benchmark will be comparable companies that quote in the stock exchange, or comparable M&A transactions that have been carried out on companies (quoting or nonquoting) that are similar to the target under appraisal. The market value of comparables (either companies or transactions) is obtained via the calculation of a multiple, a ratio of economic value which is shown in following formula.[91]

$$\text{Economic value multiple} = \frac{Equity\ value\ of\ the\ comparable\ target}{Relevant\ economic\ parameter\ of\ comparable}$$

[88] Damodaran, A. (2006) *Damodaran on Valuation: Security Analysis for Investment and Corporate Finance, 2nd edition*, John Wiley & Sons, Hoboken, NJ., pp. 9.
[89] Filipović, D. (2012.), *Izazovi integracijskih procesa: rast poduzeća putem spajanja, preuzimanja i strateških saveza*, Sinergija, Zagreb, pp. 146.
[90] Damodaran, A. (2006) *Damodaran on Valuation: Security Analysis for Investment and Corporate Finance, 2nd edition*, John Wiley & Sons, Hoboken, NJ., pp. 10-15.
[91] Pereiro, L. E. (2002.), *Valuation of Companies in Emerging Markets: A Practical Approach*, John Wiley & Sons, Hoboken, NJ, pp. 249.

The application of the multiple to the target's corresponding economic parameter makes it possible to estimate the target's market value or equity value. "After refining valuation acquirer goes through deal structuring process which can be viewed as comprising number of interdependent components, including the acquisition vehicle, post-closing organization, legal form of the selling entity, form of payment, and tax and accounting considerations."[92] The acquisition vehicle refers to the legal structure (corporation or partnership) used to acquire the target. Post-closing organization can be seen as organizational and legal framework used to manage the combined business following the completion of the transaction. Tax structure of the deal and form of payment are both affected by these considerations. Cash, common stock, debt or combination can be used as form of payment. Some portion of the payment can be dependent on the future performance of acquired entity. Accounting considerations refer to potential impact of financial requirements on the earnings volatility of business combinations.[93]

The last in the negotiation phase is developing a financial plan. "That includes developing the balance sheet, income, and cash flow statements for the combined companies. Unlike the financial projections of cash flow made to value the target, these statement should include the expected cost of financing the transaction. Developing the financial plan is key input in determining the purchase price, because it places a limitation on the amount the acquirer can offer for target."[94]

Next stage in M&A process is integration planning. It usually involves addressing human resource, costumer, and supplier issues that overlap the change of ownership. "These are transitional issues that should be solved as part of purchase agreement, and it is critical that the target's responsibilities are negotiated before closing in order to make actual transition as successful as possible."[95] Successful integration requires getting employees in both companies to work to achieve common objectives. Therefore, trust and commitment is very important in this process, and it comes from cooperation, keeping commitments, and experiencing success. It is also important that acquirer determines an integration manager who possesses excellent

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[92] DePamphilis, D. M. (2014.), *Mergers, Acquisitions, and Other Restructuring Activities*, Seventh Edition, Academic Press, San Diego, pp. 160

[93] DePamphilis, D. M. (2014.), *Mergers, Acquisitions, and Other Restructuring Activities*, Seventh Edition, Academic Press, San Diego, pp. 160-161.

[94] DePamphilis, D. M. (2014.), *Mergers, Acquisitions, and Other Restructuring Activities*, Seventh Edition, Academic Press, San Diego, pp. 164-166.

[95] DePamphilis, D. M. (2014.), *Mergers, Acquisitions, and Other Restructuring Activities*, Seventh Edition, Academic Press, San Diego, pp. 167.

interpersonal and project management skills. During integration stage of M&A, interpersonal skills are usually more important than professional and technical skills. After integration planning is done, acquirer moves to closing phase in which all necessary shareholder, regulatory, and third party contents (e.g. costumer and vendor contracts) are obtained as well as definitive purchase agreement. In the next phase, acquirer is implementing post-closing integration, practically everything that was planned within integration planning (communication plans, employee retention, employing best practices, cultural issues, etc.).[96] "Last phase in M&A process is post-closing evaluation. The primary reason for conducting a post-closing evaluation of all acquisitions is determining if acquisition is meeting expectations in order to undertake corrective actions if necessary, and to identify what was done well and what can be done better in following transactions."[97]

[96] [96] DePamphilis, D. M. (2014.), *Mergers, Acquisitions, and Other Restructuring Activities*, Seventh Edition, Academic Press, San Diego, pp. 169-176.
[97] DePamphilis, D. M. (2014.), *Mergers, Acquisitions, and Other Restructuring Activities*, Seventh Edition, Academic Press, San Diego, pp. 175.

3. CROSS-BORDER MERGERS AND ACQUISITIONS

This chapter focuses on explanation of internationalization process and its drivers, obstacles and motives for cross-border mergers and acquisitions as well as empirical evidence on cross-border M&A success.

3.1. Internationalization process and drivers

Going international presents the firm with challenges like new markets, new business models and numerous difficulties. The firm needs to define its readiness for internationalization process based on their resources and capabilities. This readiness has to be assessed in the context of the globalization or localization factors that influence the industry or industries within which the firm operates.[98]

A variety of motivators can push and pull firms along the international path. Proactive motivators represent incentives for strategic change initiated by the firm, while reactive motivators describe incentives that result in a firm's response and adaptation to external changes.[99] Profits are the major proactive motivation for international business. The profitability expected when planning to go international if often quite different from the profitability actually obtained. Profitability is often linked with international growth, yet many corporate international entry decisions are made based on expectations of market growth rather than on actual market growth.[100] Unique products or a technology advantage also can be major stimulus. Furthermore, special knowledge about foreign customers or market situations may be another stimulus, but usually as an initial stimulus for international business, but not for prolonged motivation. Only if firms build up international information advantage as an ongoing process, through for example, broad market scanning or special analytical capabilities, can prolonged corporate strategy be based on this motivation. Tax benefits and economies of scale are also important proactive motivators.[101]

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[98] Solberg, C. A. (1997.), A Framework for Analysis of Strategy Development in Globalizing Markets, *Journal of International Marketing,* 5(1): 9-30.
[99] Czinkota, M., Ronkainen, I., Moffett, M., Marinova, S., Marinov, M. (2009.), *International Business*, European Edition, John Wiley & Sons, West Sussex, pp. 217-218.
[100] Gaba, V., Pan, Y., Ungson, G. R. (2000.), Timing Entry of International Market: An Empirical Study of US Fortune 500 Firms in China, *Journal of International Business Studies,* 31(1): 39-55.
[101] Czinkota, M., Ronkainen, I., Moffett, M., Marinova, S., Marinov, M. (2009.), *International Business*, European Edition, John Wiley & Sons, West Sussex, pp. 218.

Reactive motivators influence firms to response to environmental changes and pressures. For example, a company may worry about losing domestic market share to competing firms that have benefited from the economies of scale gained through international business activities.[102] But quick entry may result in equally quick withdrawal once the firm recognizes that its proration has been inadequate. Besides the competitive pressures, overproduction may also represent a reactive motivation. But international business expansion based on overproduction does not usually represent real commitment, but rather a temporary safety valve. Declining domestic sales and excess capacity are very powerful motivators. Similarly to declining domestic sales is also saturated domestic market. A final major motivator is the physical and psychological closeness to the markets which can play a major role in the process of internationalization.[103]

In general, firms that are most successful in international arena are usually motivated by proactive factors.[104] After the assessment to internationalize, the choice of a foreign entry mode is extremely important.[105] “A company planning to conduct any business activities in a foreign market must choose an appropriate mode for this activity. Each task can be performed in various ways, including by vertically integrated organizational units in the foreign country (wholly-owned subsidiaries), by external organizational units (e.g. distributors in the foreign market), or jointly (cooperative arrangements).”[106] So the choice of a foreign entry mode is a crucial success factor furthermore since it is not effortlessly adjustable in the short-time perspective.

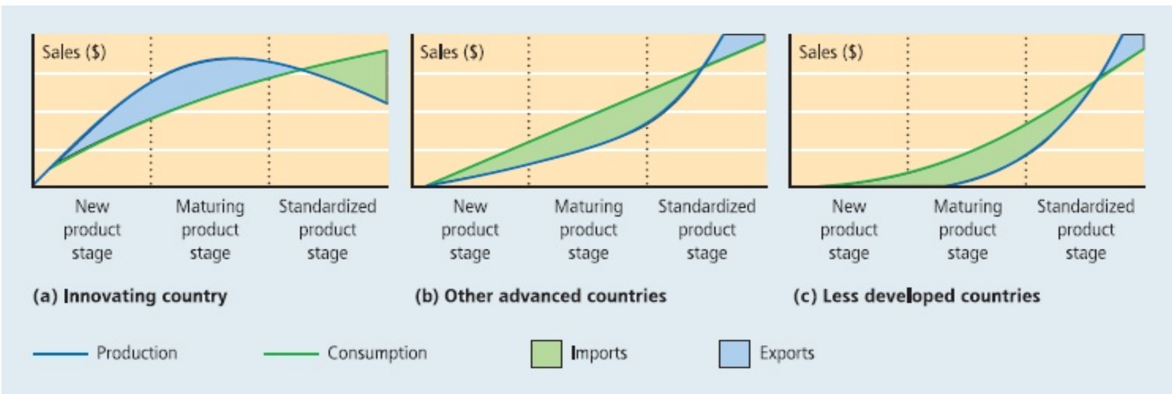
To classify foreign entry modes, it is important to stress that different academics approach these issues in divergent ways.[107] Very commonly, a distinction is made between export modes (indirect or direct export), contractual modes (licensing, franchising and contract manufacturing) and investment equity entry modes (joint ventures, wholly-owned

[102] Czinkota, M., Ronkainen, I., Moffett, M., Marinova, S., Marinov, M. (2009.), *International Business*, European Edition, John Wiley & Sons, West Sussex, pp. 219.
[103] Czinkota, M., Ronkainen, I., Moffett, M., Marinova, S., Marinov, M. (2009.), *International Business*, European Edition, John Wiley & Sons, West Sussex, pp. 219.
[104] Czinkota, M., Ronkainen, I., Moffett, M., Marinova, S., Marinov, M. (2009.), *International Business*, European Edition, John Wiley & Sons, West Sussex, pp. 220.
[105] Some authors use the term foreign operation mode instead of market entry mode. They argue that market entry suggests that the international activities are sales-related. See in: Welch, L., Benito, G., Petersen, B. (2007.), *Foreign Operation Methods - Theory, Analysis, Strategy*, Edward Elgar Publishing, Cheltenham, pp. 7.
[106] Morchett, D., Schramm-Klein, H., Zentes, J. (2010.), *Strategic International Management*, Second edition, Gabler Verlag, Wiesbaden, pp. 241.
[107] See in Matic, B. (2004.), *Međunarodno poslovanje*, Sinergija, Zagreb, pp. 168.

subsidiaries). The decision regarding foreign entry mode includes different challenges: where to locate production, whether to cooperate and whether an investment abroad should be undertaken.[108] Considering the establishment process, "joint ventures and wholly-owned subsidiaries can be established through a greenfield investment, i.e., by building a new facility in the host country, or through acquisition of existing facilities." [109]

Location decision was explained by many authors and by different factors. In the early economic approaches, location of value-added activities was explained with comparative cost advantage (Ricardo) and with relative factor endowments in a country (Heckscher-Ohlin).[110] While later, Vernon introduced the international product lifecycle theory of international trade, and argued that new product innovation are usually developed and produced in the home country, and in the later phase as competition and foreign demand rise, production is partly shifted to foreign countries closer to sales market. And in the third phase industrialized countries are still the most important, but too expensive for production, therefore the production moves to emerging countries.[111]

Figure 3.1. The international Product Life Cycle



The international product life cycle

Source: Raymond Vernon and Louis T. Wells, Jr., *The Manager in the International Economy* (Englewood Cliffs, NJ: Prentice Hall, 1991), p. 85.

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[108] Morchett, D., Schramm-Klein, H., Zentes, J. (2015.), *Strategic International Management*, Third edition, Springer Gabler, Wiesbaden, pp. 235.
[109] Morchett, D., Schramm-Klein, H., Zentes, J. (2015.), *Strategic International Management*, Third edition, Springer Gabler, Wiesbaden, pp. 235.
[110] About theories of trade and investment see in: Czinkota, M., Ronkainen, I., Moffett, M., Marinova, S., Marinov, M. (2009.), *International Business*, European Edition, John Wiley & Sons, West Sussex, pp. 21-50.
[111] Griffin, R. W., Pustay, M. W. (2005.), *International Business*, Fourth Edition, Pearson Education, Upper Saddle River, NJ., pp. 155-157.

Location theories of internationalization assume that the decision for value-added in a specific country is determined by location characteristics like market factors (market size and potential) and cost-related factors (differences in labor costs, input goods, taxes).[112] Additionally the country risk is also taken into consideration, so where the potential risk is high, optimal strategy is export or contractual arrangement because they reduce the risk exposure of the firm.[113]

The decision to establish foreign value-added activities thru cooperation or hierarchy is also influenced by several factors. The probability for a firm to use a wholly-owned subsidiary increases with: the number of employees, experience of the firm in the host country, advertising intensity of the firm and export intensity of the firm (higher percentage of foreign sales implicates the significant knowledge about the foreign market). Then again, the probability for a firm to use cooperation increases as country risk increases, also when legal restrictions in the host country are numerous, also depends on foreign market size, resource intensity and if the subsidiary is active in a business field unrelated to the business field of parent company.[114]

To explain the choice of international market entry mode, a number of different theories are used in the literature. “The stages models of internationalization, including “Uppsala model”, are rooted in the behavioral theory of the firm. These models propose an association between the knowledge of the decision makers in the company and the level of resource commitment in the foreign market.”[115] It means that as companies accumulate knowledge, they will be more committed regarding supplementary resources. “In the establishment chain, the model proposes that foreign entry modes in a specific foreign country are switched along a certain path: no international activities, export activities via agents, export activities via sales subsidiaries, and establishment of production subsidiaries.”[116] "Uppsala model"[117] suggests

[112] Morchett, D., Schramm-Klein, H., Zentes, J. (2010.), *Strategic International Management*, Second edition, Gabler Verlag, Wiesbaden, pp. 243.
[113] Morchett, D., Schramm-Klein, H., Zentes, J. (2010.), *Strategic International Management*, Second edition, Gabler Verlag, Wiesbaden, pp. 243.
[114] Morchett, D., Schramm-Klein, H., Zentes, J. (2010.), *Strategic International Management*, Second edition, Gabler Verlag, Wiesbaden, pp. 244.
[115] Morchett, D., Schramm-Klein, H., Zentes, J. (2010.), *Strategic International Management*, Second edition, Gabler Verlag, Wiesbaden, pp. 246.
[116] Morchett, D., Schramm-Klein, H., Zentes, J. (2010.), *Strategic International Management*, Second edition, Gabler Verlag, Wiesbaden, pp. 246.

that companies often select foreign markets based on the psychic distance and that internationalization often occurs along a psychic distance chain with psychological close markets being entered first and then, more distant countries.[118] In general, the common assumptions of all stages models are that internationalization is a slow and gradual process; and results of incremental decisions.[119] Also, internationalization is an adaptive process occurring in stages and during which companies accumulate experiential knowledge which facilitates foreign activities and further internationalization process.[120]

John Dunning developed eclectic theory or OLI paradigm. According to Dunning, FDI will occur when three conditions are satisfied:

1. **Ownership (O) advantage**
   The firm needs to have exceptional competitive advantage in terms of brand name, technology ownership, benefits of economies of scale etc.
2. **Location (L) advantage**
   This condition stands for conducting activities more profitable in a foreign location when compared to domestic location in terms of labor costs, tariffs etc.[121]
3. **Internationalization (I) advantage**
   The firm needs to have advantage from controlling their international activities than from contractual relationship with independent local company that provides the service.[122]

The choice of a foreign entry mode is considered as one of the most important internationalization strategy decisions. To make a rational decision on a foreign entry mode, several interconnected characteristics need to be analyzed. The following table listed the conditions of implementation, advantages and disadvantages of various entry modes.

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[117] Johanson, J., Vahlne, J. (1977.), The Internationalization Process of the Firm - A Model of Knowledge Development and Increasing Foreign Market Commitment, *Journal of International Business Studies*, 8(I): pp. 23-32.
[118] Morchett, D., Schramm-Klein, H., Zentes, J. (2010.), *Strategic International Management*, Second edition, Gabler Verlag, Wiesbaden, pp. 246.
[119] Morchett, D., Schramm-Klein, H., Zentes, J. (2010.), *Strategic International Management*, Second edition, Gabler Verlag, Wiesbaden, pp. 247.
[120] Swoboda, B. (2002.), *Dynamische Prozesse der Internationalisierung Managementtheoretische und empirische Perspektiven des unternehmerischen Wandels*, Gabler, Wiesbaden, pp. 72-73.
[121] Rugman, A., Collinson, S. (2009.), *International Business*, Fifth edition, Prentice Hall, Harlow, pp. 68-70.
[122] Morchett, D., Schramm-Klein, H., Zentes, J. (2015.), *Strategic International Management*, Third edition, Springer Gabler, Wiesbaden, pp. 131.

Table 3.1. Comparison of conditions of implementation, advantages and disadvantages of various entry modes

Entry mode	***Conditions for Implementation***	***Advantages***	***Disadvantages***
EXPORTING	• Limited sales potential of target market • High target country production costs • Liberal import policies • High level of risk	• Lowest possible investment • Gradual exposure to international markets • Lowest possible risk • Allows speedy market entry • Maximizes economies of scale of existing facilities	• High transportation costs • Prices increase due to price escalation • Tariff barriers can make exporting non-applicable • Need to use intermediaries • Limits opportunities to learn
LICENSING	• Significant import and investment barriers • Availability of legal protection of intellectual property rights • Substantial psychological distance • Licensee unlikely to become competitor	• Easy mode of entry • Entering markets with huge barriers to investment • Quick entry • Allows high returns on investment	• Control over the operations of licensee difficult • Impedes co-ordination of international operations • Cross-licensing may mitigate risk • Unfavorable spill-over effect
JOINT VENTURE	• High import barriers • High sales potential • Some risk – needs to share • Government restriction on foreign ownership • Availability of suitable partner	• Opportunities to benefit from knowledge exchange • Sharing risk • Present high learning potential	• Risk of conflict due to information asymmetry • Control proportionate to ownership participation • Difficult strategic co-ordination • Managerial issues a challenge
FDI: wholly-owned subsidiaries via building new facilities (greenfield investments) or buying existing assets (acquisitions)	• Significant import barriers • Small psychological distance • High sales potential • Low level of risk	• Increases control • Allows high flexibility in serving international markets • Quick and direct feedback from the market	• Most expensive mode of market entry • Riskiest mode of market entry • May be challenging in terms of managing local resources

Source: Czinkota, M., Ronkainen, I., Moffett, M., Marinova, S., Marinov, M. (2009.), *International Business,* European Edition, John Wiley & Sons, West Sussex, pp. 238.

Different foreign entry modes imply different levels of control, different resource commitment, flexibility and knowledge dissemination risk. The trade-off between control on the one side and the necessary resource commitment is a principal decision for a firm. “FDI as internationalization strategy involves the transfer of equity funds to other nations to gain (whole or partial) ownership and control of foreign assets. Partial ownership relates to international collaborative ventures, i.e., international joint ventures or international strategic alliances while wholly-owned subsidiaries, in contrast, represent full ownership and full control over foreign business entities.”[123] Establishing wholly-owned subsidiaries can be done in several ways. The main modes are greenfield ventures and M&A. Greenfield ventures involve the establishment of new facilities while M&A strategies or "brownfield strategies" refer to purchasing existing facilities or existing companies in the host country.[124]

M&A, as entry mode strategy, provide numerous opportunities from prompt entry into novel markets and access to distribution channels, local knowledge and contacts with local suppliers, buyers and local governments, but there are also many difficulties.[125] This will be discussed in detail in following part of the thesis.

3.2. Obstacles and motives for cross-border mergers and acquisitions

Cross-border mergers and acquisitions face many difficulties and barriers (e.g. unstable business and legislative environment) which prevent those transactions from realizing planned goals and synergies. “Structural barriers include strong power powers for supervisory boards to block mergers, unions and workers' councils have say on takeovers and strong redundancy rights; issue of bearer shares, double voting or non-voting shares, absence of one share, one vote principle; discriminatory tax laws against foreign acquirers, e.g. withholding taxes on dividends; antitrust regulation, foreign investment review, rules of stock exchange and professional self-regulatory bodies; absence of statutory or voluntary bodies to regulate takeovers and also absence of M&A services (legal, accounting, investment banking services). Technical barriers include: two-tier boards which cannot be removed or changed quickly; families dominate shareholding; powers to issue shares with differential voting rights

[123] Morchett, D., Schramm-Klein, H., Zentes, J. (2015.), *Strategic International Management*, Third edition, Springer Gabler, Wiesbaden, pp. 409.
[124] Morchett, D., Schramm-Klein, H., Zentes, J. (2015.), *Strategic International Management*, Third edition, Springer Gabler, Wiesbaden, pp. 411.
[125] Hill, C.W.L. (2013.), *International Business: Competing in the Global Marketplace*, 9th ed., McGraw-Hill, New York, pp. 501-503.

or to friendly persons; powers to limit maximum voting rights, powers to override shareholders in company's interest."[126]

"Information barriers mean following: not available accounting and audit reports, low compliance with generally accepted accounting principles, low quality of information, vague ownership structure, accounting practices implemented to try avoiding taxes, and unknown or unpredictable regulatory procedures. Finally, barriers related to tradition and culture refer to syndrome known as to "sell is to admit failure", dislike of hostile bids, dislike of institutional constraints on dividends or short-term profits; unwillingness to disclose information and high premium on trust and confidence in negotiations rather than formal contracts."[127]

Empirically, cross-border M&As can be regarded as the most relevant strategy due to many advantages, but it is also important to stress disadvantages of the M&A strategy.[128] One of the main reasons for failure results from the fact that purchasing of all valuable assets of the target, also means purchasing of all liabilities especially hidden liabilities like poor labor relations or unfunded financial obligations.[129] Additional problem in M&A strategy is calculation of an adequate price for takeover candidate as well as integration problems like necessity of coordination and integration of heterogeneous structures, systems and cultures as well as resistances of host country government and management.[130]

There are various motives for cross-border mergers and acquisitions. When engaging in mergers and acquisitions primarily motive for all M&A participants in creation of synergy. "Synergy is additional value that is generated by combining two firms, creating opportunities that would not have been available to these companies before operating independently."[131] Potential sources of synergy can be grouped in two categories – operating and financial

[126] Sudarsanam, S. (2003.), *Creating Value from Mergers and Acquisitions*, Prentice Hall International Limited, London, pp. 205; Morschett, D., Schramm-Klein, H., Zentes, J. (2015) *Strategic International Management, 3rd Edition*, Springer, Wiesbaden, pp. 415.
[127] Sudarsanam, S. (2003.), *Creating Value from Mergers and Acquisitions*, Prentice Hall International Limited, London, pp. 205; Morschett, D., Schramm-Klein, H., Zentes, J. (2015) *Strategic International Management, 3rd Edition*, Springer, Wiesbaden, pp. 415.
[128] Hill, C. (2009.), *International Business - Competing in the Global Marketplace*, Seventh International ed., McGraw-Hill, New York, pp. 503.
[129] Griffin, R., Pustay, M. (2010.), *International Business*, Global Edition, Prentice Hall, Upper Saddle River, NJ, pp. 382.
[130] Morchett, D., Schramm-Klein, H., Zentes, J. (2010.), *Strategic International Management*, Second edition, Gabler Verlag, Wiesbaden, pp. 309.
[131] Damodaran, A. (2006.), *Damodaran on Valuation: Security Analysis for Investment and Corporate Finance, 2nd edition*, John Wiley & Sons, Hoboken, NJ, pp. 541.

synergies. Operating synergies affect operations of companies involved in M&A and include economies of scale and scope, responding to domestic market decline, spreading risks, and increasing capabilities through combination of different functional strengths. Operating synergies often show up as higher expected cash flows. In contrast, financial synergies, are more focused and include financial and tax efficiency, asset striping, and uses of excess cash, higher debt capacity, and diversification. They sometimes show up as higher cash flows and also take from of lower discount rates.[132]

Economies of scale (briefly discussed in section 2.2.) is defined as "reduction in average total costs for a firm producing a single product for a given scale of plant due to the decline in average fixed costs as production volume increases. Scale is defined by such fixed costs as depreciation of equipment and amortization of capitalized software, regular maintenance spending, and obligations such as interest expense, lease payments,"[133] costumer and vendor contracts and taxes. Since these cost cannot be altered in short run – they are fixed. Costs that change with output levels are variable costs. Therefore, with the increase in the volume of production average costs of production are decreased when fix costs are spared over larger number of the same product.[134] Economies of scale was one of the motives of BAT to acquire TDR because TDR had a new production factory which did not operate with full capacity thus opening a space for exploiting economies of scope for BAT.

Companies can be motivated to internationalize thought cross-border M&As not only because they want to achieve economies of scale, but also because of potential cost reductions which can be achieved through economies of scope. When companies engaged in cross-border mergers and acquisition can share marketing, distribution costs, production and development economies of scope can be realized.[135] Using the same brand across several products can result in increased revenues. In case of BAT – TDR acquisition potential economies of scope can be achieved through joint distribution of cigarettes since TDR owns retail chains iNovine and Opresa and TDR is well positioned in leading retailers in the Republic of Croatia. Therefore, BAT can increase sales of their own brands in future by using same distribution

[132] Damodaran, A. (2006.), *Damodaran on Valuation: Security Analysis for Investment and Corporate Finance, 2nd edition*, John Wiley & Sons, Hoboken, NJ, pp. 541.
[133] DePamphilis, D. M. (2014.), *Mergers, Acquisitions, and Other Restructuring Activities*, Seventh Edition, Academic Press, San Diego, pp. 6.
[134] DePamphilis, D. M. (2014.), *Mergers, Acquisitions, and Other Restructuring Activities*, Seventh Edition, Academic Press, San Diego, pp. 6.
[135] Huff, A. S. et al. (2009.), *Strategic Management: Logic & Action*, John Wiley & Sons, Hoboken, NJ, pp. 239.

channels like TDR. Greater pricing power and higher market share could impact on higher margins and operating income as a result of mergers and acquisitions thus creating operating synergy. “This synergy is more likely to show up in cross-border mergers and acquisitions in same business and should be more likely to yield benefits when there are relatively few companies in specific market.”[136]

Responding to domestic market decline can be a motive for cross-border acquisitions. Conventional financial theory suggests that it is usually best to let shareholders find new growth investment opportunities for themselves rather than let managers of declining business invest spare funds in new businesses. Engaging in cross-border acquisitions can be a good decision in the declining market like it was case of Croatian tobacco industry. TDR found itself in the situation of continuous declined in sales revenues from 2008 and that negative trend in its business performance was definitely a motive for transaction that occurred.

Companies can be motivated to start with cross-border mergers and acquisitions in order to spread risks to other geographical areas, markets and products, and also to increase its capabilities. Acquisitions can be used to quickly extend international reach. In 2010 the Swedish car company Volvo was acquired by Chinese car company Geely. Geely wanted to increase its global presence, and to gain access to technological capabilities of Volvo. Soon after the acquisition Volvo heavily increased its presence on Chinese market, and Geely's perception in car industry as a cheap car producer decreased. Cisco and Microsoft, leading high-tech companies, acquire entrepreneurial technology companies as a part of their research and development strategies. Instead of developing new technology from start, they allow entrepreneurial start-up to test their technologies, and then if prove successful, they acquire these companies in order to incorporate the technological capability in their own portfolio.[137]

Financial motives for cross-border acquisitions can be observed through financial and tax efficiency as well as asset stripping or unbundling. Sometimes it can be efficient to bring together a company with a strong balance sheet with another company with weak balance sheet. The company with a weak balance sheet can reduce its interest payments by using

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[136] Damodaran, A. (2006.), *Damodaran on Valuation: Security Analysis for Investment and Corporate Finance, 2nd edition*, John Wiley & Sons, Hoboken, NJ, pp. 542.
[137] Johnson, G., Whittington, R., Scholes, K. (2012.), *Fundamentals of Strategy, 2nd edition*, Pearson, Harlow, pp. 211.

stronger company's assets to pay off its debt.[138] Besides, both acquirer and target can reduce cost of capital due to mergers and acquisitions – they can achieve financial synergy. If companies involved in transaction have cash flows that are relatively uncorrelated, cost saving can be realized from lower transaction and securities' issuance costs.[139] "Financial strategy can also be realized in cross-border acquisitions when acquirer is a company with excess cash and limited project opportunities, and target has high-return projects and limited cash position. The increase in value comes from the projects that can be undertaken with excess cash that otherwise would not have been undertaken. Financial synergy is likely to show up most often when smaller companies are acquired by larger firms, or when publically traded firms acquire private businesses. Diversification is also a source of financial synergy but most controversial one. In most of publicly traded companies investors can diversify at far lower cost and with more ease than can company itself. For closely held companies or private businesses there can be potential benefits from diversification."[140]

Sometimes, tax advantages can occur as a result of cross-border mergers and acquisitions. For example, target may be operating in a country with low taxes, and profits from the acquirer from the high tax area can be transferred to a country with lower taxes. Besides, if acquirer is high profit company it can buy target that has accumulated loses in order to reduce its own tax liability. Companies can also be motivated to engage in cross-border acquisitions in order to gain benefits from asset stripping or unbundling. If the acquirer finds a target whose underlying assets are worth more than the price of the company as a whole those assets can be quickly sold after the acquisition, and acquirer can benefit from selling off these assets at higher price than was paid for whole target.[141]

Along with synergy as a primarily motive to engage in internationalization through cross-border acquisitions companies are also motivated with utilization of lower raw material and labor costs, avoiding entry barriers and fluctuating exchange rates. Emerging markets can often offer lower low labor costs, access to inexpensive raw materials, and lower levels of regulation. Therefore, acquiring companies in emerging markets allows companies to reduce

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[138] Johnson, G., Whittington, R., Scholes, K. (2012.), *Fundamentals of Strategy, 2nd edition*, Pearson, Harlow, pp. 211.

[139] DePamphilis, D. M. (2014.), *Mergers, Acquisitions, and Other Restructuring Activities*, Seventh Edition, Academic Press, San Diego, pp. 7.

[140] Damodaran, A. (2006.), *Damodaran on Valuation: Security Analysis for Investment and Corporate Finance, 2nd edition*, John Wiley & Sons, Hoboken, NJ, pp. 542-543.

[141] Johnson, G., Whittington, R., Scholes, K. (2012) *Fundamentals of Strategy, 2nd edition*. Harlow, England: Pearson, pp. 211.

its operating expenses and become more competitive globally. Governments can sometimes impose legislation framework which protects domestic companies through setting quotas and tariffs for foreign companies. Cross-border acquisitions can help companies to circumvent such entry barriers. Decisions on when and where to acquire a company are also affected by changes in currency values. For example, if acquirer is considering to buy a target in United States, and if there is appreciation of it domestic currency relative to dollar the overall cost of acquisition will be lower. There are lot of studies that show how important is the impact of exchange rates on cross-border acquisitions.[142]

3.3. Empirical evidence on cross-border mergers and acquisitions success

The profitability of cross-border mergers and acquisitions has been analyzed for many years. It is important to stress that most empirical research in the leading academic research journals has been done in Anglo-Saxon geographical settings. For example, in their paper, "Tuch and O'Sullivan presented a review of empirical research on the impact of acquisitions on company performance. Out of 78 presented empirical studies 51 merger studies are from the US market, 24 mergers are from the UK market, and the remaining 3 merger studies are from the other EU countries."[143] Furthermore, "research on mergers and acquisitions has been done extensively in 1980s and 1990s and a relatively low number of studies have been done recently. It is believed that mergers performed prior to 1990's are quite different than those done later because of the different economic and other factors outside of the company."[144] Research on cross-border M&A is mostly divided in three segments: success of bidder companies, success of target companies and shareholder wealth effects.

Success of bidder companies

Over last thirty years scientists and academics tried to resolve the dilemma of whether the acquirer and the target company operate better or worse after the cross-border merger or the cross-border acquisition. They have not yet reached an agreement on this matter. Numerous studies have shown that acquisitions result in better business performance in the period after

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[142] DePamphilis, D. M. (2014.), *Mergers, Acquisitions, and Other Restructuring Activities*, Seventh Edition, Academic Press, San Diego, pp. 664-646.

[143] Tuch, S., O'Sullivan, N. (2007.), The Impact of Acquisition on Firm's Performance: A Review of the Evidence, *International Journal of Management Reviews*, 9: 141-170.

[144] Kukalis, S (2007.), Corporate Strategy and Company Performance - The Case of Post-Merger Performance, *The International Journal of Finance*, 19(3): 4475- 4489.

the transaction, but there are a large number of studies with contrasting effects. Linn and Switzer "explored the relationship between the profitability of the merged companies and the form of payment (cash or shares) on a sample of 413 transactions. The authors note that a change in profitability was significantly higher in the situation when the transaction was paid by the bidder in cash rather on comparison to payment in shares."[145]

Healy, Palepu and Ruback used accounting information of the target company and the bidder in order to get a picture of their business performance before the cross-border merger. Authors measured the change in business performance through linking the performance of the combined company after the cross-border merger with the joint business before the merger. "Measure of performance success was EBIT for the period of five years before the transaction and during the first year after the transaction. In the period of five years before the transaction operating returns on the sample of 50 companies range from 26 to 27.50%, while a year after the transaction operating returns range from 19 to 23%. These measures suggest that the company's performance had a negative trend in period after the transaction."[146]

Ravenscraft and Scherer analyzed takeovers "in the period from the start of the transactions until three years after it, and based on the ratio of earnings before interest and taxes (EBIT) to total assets, came to the conclusion that the takeovers result in worse company's performance in comparison to the period before the transaction. In this study of 62 transactions, Ravenscraft and Scherer used indicators related to the cash flow and came to the conclusion that the performance did not change compared with the period prior to the transaction."[147]

Furthermore, Martynova, Oosting and Renneboog analyzed the long-term profitability of 155 European acquisitions in the period from 1997 to 2001 and they used EBITDA as a measure of profitability since it can be used as an alternative to cash flow indicators. The authors found that the profitability of the combined company is significantly reduced after the acquisition. Nonetheless, "the decrease in profitability becomes irrelevant when compared with the operating results of similar companies in the industry, so they concluded that the decrease in

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[145] Linn, S., Switzer, J. (2001.), Are cash acquisitions associated with better post combination operating performance than stock acquisitions?, *Journal of Banking and Finance*, 25(6): 1113-1138.
[146] Healy, P. M., Palepu, K. G., Ruback, R. S. (1992.), Does corporate performance improve after mergers?, *Journal of Financial Economics*, 31(2): 135-145
[147] Ravenscraft, D. J., Scherer, F. M. (1989.), The Profitability of Mergers, *International Journal of Industrial Organization,* 7(1): 101-116.

profitability is not related to the acquisition, but that is rather a matter of macroeconomic changes that affect all companies in the industry."[148]

"On a sample of 191 takeovers in the period from 1985 to 1993 Powell and Stark came to the conclusion that there are significant changes in the bidders' business performance in the period after the takeover, compared with performance in the period before the acquisition."[149] Mueller investigated 247 companies that participated in transactions in the USA from 1962 to 1972, and he concluded that there has been a decrease in key financial indicators (ROE, ROA and ROS) in the period of three years after the takeover.[150]

"Clark and Ofek found that EBITDA/sales ratio decreased two years after the acquisition. Dickerson, Gibson and Tsakalotos analyzed 2.914 companies in the period of five years after the transaction, and they noticed that return on assets declined in comparison to the performance in the year when the transaction occurred."[151] Whereas, Ghosh emphasized that the change in business performance, measured as the operating cash flow after the acquisition, is not statistically significant.[152]

Evidently it is impossible to make general conclusion regarding the matter of company's performance after the takeover. It is important to stress that the use of financial indicators when evaluating business performance is sensitive to the different accounting policies, and financial statements are subject to possible manipulations that reflect on the research results.[153]

Success of acquired companies

Similarly to the research on the success of bidder companies, "numerous empirical studies about target company's success after the takeover offer inconsistent results since some of

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148 Marynova, M., Oosting, S., Renneboog, L. (2006.), *The long-term operating performance of European mergers and acquisitions*, European Corporate Governance Institute, Amsterdam.
149 Powell, R. G., Stark, A. W. (2005.), Does operating performance increase post-takeover for UK takeovers? A comparison of performance measures and benchmarks, *Journal of Corporate Finance*, 11(1): 293-317.
150 Mueller, D. C. (1985.), Mergers and Market Share, *The Review of Economics and Statistics*, 67(2): 259-267.
151 Dickerson, A., Gibson, H., Tsakalotos, E. (1997.), The Impact of Acquisitions on Company Performance: Evidence From a Large Panel of U.K. Firms, *Oxford Economic Papers,* 49(3): 344-361.
152 Ghosh, A. (2001.), Does Operating Performance Really Improve following Corporate Acquisitions?, *Journal of Corporate Finance*, 7(2): 151-178.
153 Filipović, D. (2012.), *Izazovi integracijskih procesa: rast poduzeća putem spajanja, preuzimanja i strateških saveza*, Sinergija, Zagreb, pp. 35.

them show significant improvements in the business performance after the transaction, some of them proved that company's performance is worse after the transaction while others did not identified any change in company's performance."[154]

These researches are largely based on the accounting methodology where return on equity (ROE), return on assets (ROA) and return on sales (ROS) are typically calculated for a period of three years after the takeover, and these returns are then compared with the performance of the target company in the period before the takeover. These accounting indicators show actual returns achieved by the company after the acquisition, even though various accounting policies allow manipulation of financial statements. Analysis of financial statements is used when takeover success of companies that are not listed on the stock exchange is analyzed.

Furthermore, in order to compare prior and post-transaction performance, researchers construct aggregate indicators for the bidder and the target company, and compare them with performance indicators of the company which continues to operate after the transaction.[155] For example, Aureli analyzed the performance of unlisted Italian companies acquired by Indian multinationals and she concludes that foreign investors mainly search for know-how and technical expertise and their arrival does not lead to better financial performance. Only one target recorded profits. Nevertheless Indian investors were not destroying profitable organizations as these were recording negative results already before the merger. With reference to value added distribution, according to Aureli, acquisitions do not reduce local stakeholders' wealth for the benefits of shareholders.[156]

Damijan, Kostevc and Rojec analyzed the impact of foreign acquisition on the performance of acquired firms in seven new EU member states (Bulgaria, Estonia, Czech Republic, Poland, Romania, Slovenia and Slovakia) in the period between 1997 and 2009, and assessed "the extent to which this is due to target selection and/or post-acquisition improvements. To distinguish between pre and post-acquisition differences between foreign-acquired and domestic firms, they explored the productivity gaps from three years before the acquisition up

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[154] Marynova, M., Oosting, S., Renneboog, L. (2006.), *The long-term operating performance of European mergers and acquisitions*, European Corporate Governance Institute, Amsterdam, pp. 3.
[155] Filipović, D. (2012.), *Izazovi integracijskih procesa: rast poduzeća putem spajanja, preuzimanja i strateških saveza*, Sinergija, Zagreb, pp. 33.
[156] Aureli, S. (2015.), Performance of unlisted Italian companies acquired by multinationals from emerging markets: The case of Indian acquisitions, *Journal of Organizational Change Management*, 28(5): 895-924.

to three years after the event."[157] They concluded that "productivity of firms acquired in cross-border acquisitions tends to increase after the acquisitions, while the impact on employment is uncertain. They explained that part of an increase in productivity may be due to 'cherry picking', that is, selection of best performing firms by foreign investors. The opposite mechanism may also be at work, that is, foreign investors may select 'lemons', underperforming firms with promising growth potential. They also identified that trends in post-acquisition productivity growth may also be conditional on a number of additional factors."[158]

Futhermore, Strasek and Gubensek examined pre- and post-acquisition performance of 29 acquired companies in Slovenia. The focus was the on analysis of median values on different financial rates and they tried to empirically test the difference in long-term operating performance of the selected financial ratios before and after the transaction of acquired firms between 2005 and 2008. The data was collected for all sample units for 4 years before transaction and 4 years after the acquisition and they suggested that an increasing trend of indebtedness was present, pointing to the typical characteristic of M&A deals, where the burdens from takeovers are brought on a target company.[159]

Bebenroth and Hemmert also examined "the post-acquisition business performance of target firms. For 109 Japanese and South Korean acquisition targets, they found negative effects of managerial distance on target firms' post-acquisition ROA development and of cultural distance on their asset growth. Furthermore, firms acquired by emerging-market multinationals recorded relatively higher ROA development and lower asset growth than other target firms. They suggested that multiple performance dimensions should be considered to assess the outcomes of international M&As accurately."[160]

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[157] Damijan, J., Kostevc, C., Rojec, M. (2015.), Growing Lemons or Cherries? Pre and Post-acquisition Performance of Foreign-Acquired Firms in New EU Member States, *The World Economy*, 38(4): 751-772.
[158] Damijan, J., Kostevc, C., Rojec, M. (2015.), Growing Lemons or Cherries? Pre and Post-acquisition Performance of Foreign-Acquired Firms in New EU Member States, *The World Economy*, 38(4): 751-772.
[159] Strasek, S., Gubensek, A. (2016.), Pre- and Post-Acquisition Performance of Acquired Firms in a Small Transition Economy, *Actual Problems in Economics*, 178: 133-142.
[160] Bebenroth, R., Hemmert, M. (2015.), Country-level antecedents of target firms' post-acquisition business performance: A study of inbound Japanese and Korean M&As, *Asian Business & Management,* 14(4): 303-325.

Shareholder wealth and cross-border M&A

Analysis of shareholder wealth should be separated in two segments which comprise of the impact of cross-border M&A on target's shareholder wealth and the impact of cross-border M&A on bidder's shareholders wealth. "At the time of the transaction announcement, the total earnings of the acquirer's and the target's shareholders are in total positive, but the target company's shareholders earn much more than the acquirer's shareholders. Empirical researches confirm that the price of target company's shares at the time of the transaction announcement rises considerably."[161] In addition, usually three to five years after the transaction acquirers operate worse in comparison to the industry average and this causes the value loss of their shares, and consequently decreases the wealth of shareholders. DePamphilis emphasized that the reasons for the destruction of the value is very difficult to relate exclusively to the cross-border M&A since it can be related to other external and internal variables.[162]

Initial part of the analysis is concentrated on the target's shareholder wealth. Schwert verified that the stock price movement of the target company is easily affected not only on the announcement day but also in the period of 42 days prior to the announcement.[163] Marynova and Renneboog suggest that a rise in the target's share price in the period of one month before the takeover is high and it surpasses the price increase on the announcement day. Premiums gained by the target's shareholders during this period range from 13.32 to 21.80%. Such returns imply that the takeovers are anticipated, and that the unexpected price jumps occur as a consequence of rumors, information leaks or insider trading.[164] According to the research by Eckbo and Langohr conducted on a sample of 90 companies in France, shareholders of the acquired companies achieved significant positive returns on the day and the day after the

[161] Filipović, D. (2012.), *Izazovi integracijskih procesa: rast poduzeća putem spajanja, preuzimanja i strateških saveza*, Sinergija, Zagreb, pp. 36-40.
[162] DePamphilis, D. M. (2010.), *Mergers, Acquisitions, and Other Restructuring Activities,* Fifth edition, Academic Press, San Diego, pp. 30.
[163] Schwert, G. W. (1996.), Markup Pricing in Mergers and Acquisitions, *Journal of Financial Economics*, 41(2): 153-192.
[164] Marynova, M., Renneboog, L. (2008.), A century of corporate takeovers: What have we learned and where do we stand?, *Journal of Banking and Finance*, 32, (10): 2153.

takeover announcement.[165] A cumulative average abnormal return for shareholders of the acquired companies was 16%.[166]

Graham, Lemmon and Wolf also identified high returns for shareholders of the acquired companies. The shareholders of acquired companies achieved a cumulative average return of 22.51%.[167] Li found "that bank mergers and acquisitions do create shareholder wealth for the target bank acquired and that in many cases the acquiring firm's shareholders tend to lose out because their ownership in the newly formed bank is severely diluted and the same is with the efficiency."[168]

Sharma and Raat examined "125 cross-border acquisitions in which developed-market firms from France, Germany, Netherlands, and the United Kingdom acquired ownership stakes in emerging as well as developed-markets in Europe during the period January 2000 through December 2011."[169] Evidence suggested "that when the target firm is located in the Czech-Republic, Hungary, Poland, or Russia, cumulative abnormal return (CAR) to the acquiring developed-market firm shows a statistically significant increase of 1.26% over a three day event window, following the announcement. Thereby, the relative size of the acquirer to the target appears to be the only significant factor that contributes to positive acquirer returns. Moreover, cross-border M&A involving an emerging-market target result in higher value creation for the acquiring shareholders than cross-border transactions into developed-markets."[170]

Also, "several studies that have looked at cross-border mergers and acquisitions financed by stock swaps showed that shareholders in these cases do not receive returns, then they lose, and

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[165] This research was conducted in the period from 1960 to 1970 conducted on a sample of 90 companies in France.
[166] Eckbo, B. E., Langhor, H. (1989.), Information Disclosure, Method of Payment, and Takeover Premiums: Public and Private Tender Offers in France, *Journal of Financial Economics*, 24(2): 363-403.
[167] This study included 356 takeovers and transactions were analyzed in the period of the day before and the day after the takeover announcement. Graham, J., Lemmon, M., Wolf, J. (2002.), Does corporate diversification destroy value?, *Journal of Finance*, 57(2): 695-720.
[168] Li, T. (2016.), A study on the impact of mergers & acquisitions on shareholders' wealth and efficiency, *ICITCE 2015 – 3rd International Conference on Information Technology and Career Education*, *SHS Web of Conferences*, 5, 02013.
[169] Sharma, A., Raat, E. (2016.), Acquiring control in emerging markets: Foreign acquisitions in Eastern Europe and the effect on shareholder wealth, *Research in International Business and Finance*, 37: 153-169.
[170] Sharma, A., Raat, E. (2016.), Acquiring control in emerging markets: Foreign acquisitions in Eastern Europe and the effect on shareholder wealth, *Research in International Business and Finance*, 37: 153-169.

on the other hand, when the takeovers are paid in cash shareholders gain positive returns."[171] Research on the effects of takeovers on the bidder's shareholder wealth diverges. "Unlike the returns gained by the target companies' shareholders, bidders' shareholder returns are modest and often negative. Average returns of the bidder's shareholders are close to zero."[172] "Studies that analyzed the return of bidders' shareholders in the period from 1970 to 1980 found that their cumulative losses ranged from 1.20% to 0.70%."[173] Jensen and Ruback analyzed the takeovers from 1958 to 1981 and concluded that in the period from 20 days before and 60 days after the takeover bidders' share prices increased on average by 4%.[174]

Results of research on takeovers during the 1990s differ in terms of bidders' shareholder returns. "In a survey of 961 takeovers in USA, in the period from 1987 to 1996, Kohers and Kohers came to the conclusion that the bidder's shareholders achieved cumulative returns of 1.37%."[175] Lehn and Zhao analyzed "the bidder's shareholder returns in the period of five days before to 40 days after the transaction on a sample of 61 takeovers and showed that the shareholders' cumulative loss was 7.03%."[176] Ang and Cheng analyzed "848 takeovers and their impact on shareholder's wealth in the interval of one day before the transaction announcement and came to the conclusion that in these transactions shareholders cumulatively lost 0.48% of their share value."[177]

Studies that have analyzed "the long-term impact of takeovers (usually a month or two after the takeover) differ depending on the type of takeover, payment method and takeover strategy of acquisitions. The cumulative average abnormal returns for bidder's shareholders are

[171] Rani, N., Yadav, S. S., Jain, P. K. (2016.), Abnormal Returns in Cross-Border and Domestic Acquisitions by Indian Firms: Impact of Method of Payment and Type of Target Firms, *South Asian Journal of Management*, 21(1): 84-116.; Sudarsanam, S., Mahate, A. A. (2003.), Glamour Acquirers, Method of Payment and Post acquisition performance: The UK evidence, *Journal of Business Finance and Accounting*, 30(1-2): 299-342.; Kyriazopoulos, G. (2016.), Wealth Effects from Banks Mergers and Acquisitions in Eastern Europe, *International Journal of Economics and Financial Issues*, 6(2): 588-595.
[172] Marynova, M., Renneboog, L. (2008.), A century of corporate takeovers: What have we learned and where do we stand?, *Journal of Banking and Finance*, 32, (10): 2159.
[173] Byrd, J., Hickman, K. (1992.), Do Outside Directors Monitor Managers? Evidence from Tender Offer Bids, *Journal of Financial Economics*, 32(2): 195-221.; Chang, S. (1998.), Takeovers of privately held targets, methods of payment, and bidder returns, *Journal of Finance*, 53(2): 773-784.
[174] Jensen, M. C., Ruback R. S. (1983.), The Market for Corporate Control: The Scientific Evidence, *Journal of Financial Economics*, 11(1): 1-61.
[175] Kohers, N., Kohers, T. (2000.), The Value Creation Potential of High-Tech Mergers, *Financial Analysts Journal*, 53(3): 40-48.
[176] Lehn, K., Zhao, M. (2006.), CEO turnover after acquisitions: are bad bidders fired?, *Journal of Finance*, 61(4): 1759-1811.
[177] Ang, J. S., Cheng, Y. (2006.), Direct Evidence On The Market-Driven Acquisitions Theory, *Journal of Financial Research*, 29(2): 199-216.

significantly higher in the situation of a friendly takeover than those in the situation of a hostile takeover."[178] Many studies have shown that "in the cases of horizontal acquisitions the returns to bidder's shareholders are significantly higher than those in vertical acquisitions. Several studies also support the hypothesis that higher returns for the bidder's shareholders occur when the target companies are not listed on the stock exchange."[179]

Colombage, Gunasekarage and Shams "analyzed large sample evidence on return performances of Australian acquirers who bid for public and private targets in cross-border acquisitions."[180] They analyzed "the impact of various bid, firm and foreign-acquisition-specific characteristics on bidding firms' abnormal returns. They found that Australian investors perceive cross-border acquisitions as value-creating exercises regardless of the organizational form of the target acquired. However, bidders for private targets earned higher return when the method of payment is stock and the targets were located in high investor protection countries. They also found that the abnormal returns are conditional to the relative size of the target, bid frequency, target country destination and the pre-acquisition financial performance of bidding firms."[181]

In studies that have been conducted in the USA "there is a consensus on the matter of shareholder returns with respect to the ways of funding the transaction. In all transactions financed exclusively through shares, shareholders can experience significant losses, while the transactions paid in cash generate fewer losses."[182] Unlike the USA, "the results of studies in Europe show positive average returns for bidder's shareholders in situations when the takeover is funded through exchanging shares."[183]

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[178] Hostile takeovers reduce the value of the acquirer from 3 to 5%. 110. In: Goergen, M., Renneboog, L. (2004.), Shareholder Wealth Effects of European Domestic and Cross-Border Takeover B ids, *European Financial Management*, 10(1): 9-45.

[179] Netter, J., Stegemoller, M., Wintoki, J. (2009.), Are Small Mergers Important?: A study of over 250,000 (or less) mergers and acquisitions from 1992-2009, *University of Georgia Working Paper.*

[180] Colombage, S. R. N., Gunasekarage, A., Shams, S. M. M. (2014.), Target's organizational form and returns to Australian bidders in cross-border acquisitions, *Accounting and Finance,* 54: 1063–1091.

[181] Colombage, S. R. N., Gunasekarage, A., Shams, S. M. M. (2014.), Target's organizational form and returns to Australian bidders in cross-border acquisitions, *Accounting and Finance,* 54: 1063–1091.

[182] Research by Savor and Lu showed that the value of the bidder's shares, when using stocks as a method of payment in the first year after the takeover, fell by 7%, while the cumulative decline for three years after the takeover was 13%. 248. In: Savor, P. G., Lu, Q. (2009.), Do Stock Mergers Create Value for Acquirers?, *Journal of Finance*, 64(3): 1061-1097.

[183] Marynova, M., Renneboog, L. (2008.), A century of corporate takeovers: What have we learned and where do we stand?, *Journal of Banking and Finance*, 32(10): 2160.

Evidently, it is impossible to make universal conclusions regarding on the impact of cross-border M&A on bidder's shareholder wealth, even though the bidder's shareholders tend to generate negative returns or slightly above zero.

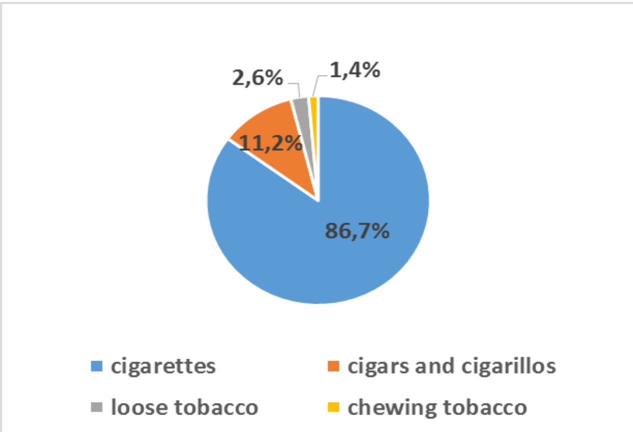
4. STRATEGIC ANALYSIS OF GLOBAL TOBACCO INDUSTRY

In this chapter strategic analysis of global tobacco industry was conducted through analysis of competitive forces in the industry, analysis of leading corporations in industry, and analysis of all cross-border acquisitions that occurred in last sixteen years.

4.1. Competitive forces analysis of global tobacco industry

The tobacco industry consists of retail sale of cigarettes, loose tobacco, chewing tobacco, and cigars and cigarillos. Despite many nations adopting legislation banning advertisement and promotion of tobacco products, the banning of smoking in public places and the requirement of various health warnings on packaging, the global tobacco has performed healthily over the last five years, and achieved steady growth. Cigarettes were the biggest segment of this market in value terms and accounted for almost 86.7% of sales. "In 2014 global tobacco industry had total revenues of $900.8 billion $ with a compound annual growth rate (CAGR) of 4.2% between 2010 and 2014. In comparison, the European and Asia-Pacific[184] markets grew with CAGRs of 2.1% and 5.7% respectively, over the same period, to reach respective values of 239.0 billion $ and 444.9 billion $ in 2014."[185]

Figure 4.1. Global tobacco market category segmentation in 2014



Source: MarketLine (2015.), *Industry Profile: Global Tobacco*, Datamonitor, London, pp. 9.

Sales of tobacco products are shifting from developed markets to emerging markets like those in Asia and Africa where tobacco companies take full advantage of lax regulatory environments, growing populations and increasing incomes. In developed countries

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[184] Asia-Pacific market comprises Australia, China, Hong Kong, India, Indonesia, Kazakhstan, Japan, Malaysia, New Zealand, Pakistan, Philippines, Singapore, South Korea, Taiwan, Thailand, and Vietnam.
[185] MarketLine (2015.), *Industry Profile: Global Tobacco*, Datamonitor, London, pp. 7.

companies are more restricted by government policies and growing social awareness of health issues. Independent retailers account for the largest proportion of sales in the global tobacco market in 2014, sales through this channel "generated 166.2 billion $, equivalent to 18.5% of the market's overall value. In 2014 sales through supermarkets/hypermarkets generated revenues of 143.1 billion $, equating to 15.9% of the market's aggregate revenues."[186]

Table 4.1. Forecast of the global tobacco industry value in period 2015-2019

Year	Billion USD	Growth %
2015	951,9	5,7%
2016	996,2	4,7%
2017	1.043,6	4,8%
2018	1.094,6	4,9%
2019	1.147,6	4,8%
CAGR: 2015 – 2019		**4,98%**

Source: MarketLine (2015.), *Industry Profile: Global Tobacco*, Datamonitor, London, pp. 13.

"The performance of the market is forecast to accelerate, with an anticipated CAGR of 5% for the five-year period 2015 - 2019, which is expected to drive the industry to a value of 1,147.6 billion $ by the end of 2019. Comparatively, the European and Asia-Pacific markets will grow with CAGRs of 2.8% and 6.7% respectively, over the same period, to reach respective values of 274.4 billion $ and 616.0 billion $ in 2019."[187]

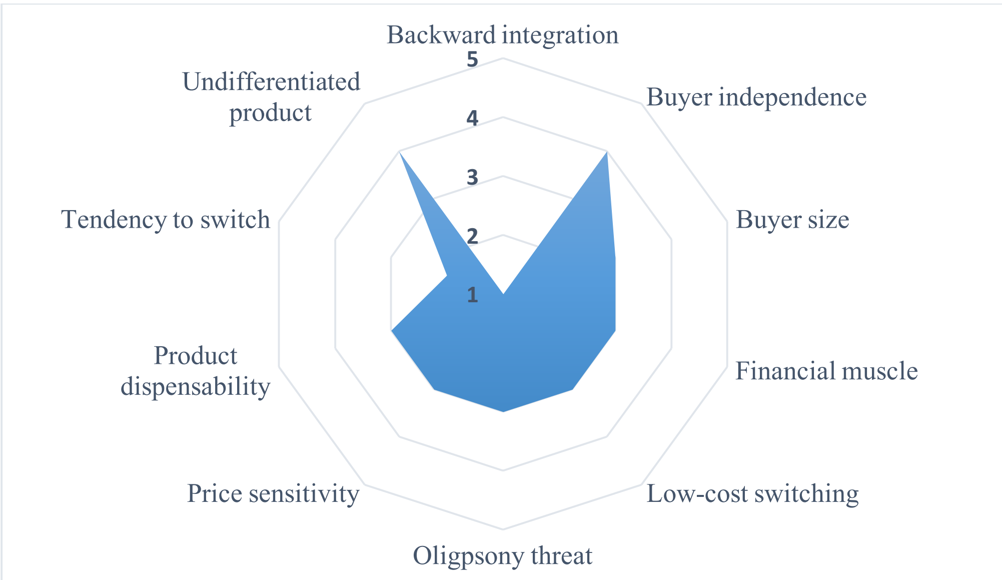
The tobacco industry is analyzed by using Porter's five forces of competition framework.[188] Tobacco and by focusing on tobacco manufacturers as players. Retailers are observed as key buyers, and tobacco farmers as the key suppliers which produce tobacco and other key raw materials necessary for production of tobacco products.

Tobacco products are sold through a relatively diverse range of retail outlets, and therefore "retailers are observed as buyers in the tobacco industry. The main retailers of the global tobacco industry include independent retailers, supermarkets/hypermarkets, and convenience stores. In the tobacco industry the concentration of retail outlets is relatively fragmented, as there are a number of outlets where the products can be sold. In the global market, independent retailers are the most dominant distribution channel. Increasing tax on tobacco

[186] MarketLine (2015.), *Industry Profile: Global Tobacco*, Datamonitor, London, pp. 7.
[187] MarketLine (2015.), *Industry Profile: Global Tobacco*, Datamonitor, London, pp. 7.
[188] Grant R. M. (2010.), *Contemporary Strategy Analysis*, 7th edition, John Wiley & Sons, West Sussex, pp. 69-79.

products is likely to reduce the demand for tobacco products, which could result in retailers reducing their stocks, in-turn increasing buyer power."[189] Additional factor that has impact on tobacco demand is the regulation of tobacco products such as bans on smoking in public spaces, warning labels on packaging and the regulation of the advertising and promotion of tobacco. Besides, increased public awareness and knowledge of the damage that tobacco products can have to health can also impact the demand. Furthermore, "tobacco products are just one of many products sold by most retailers, which illustrates that in most cases retailers are not reliant upon tobacco sales, which further increases buyer power. However, customers are likely to be loyal towards certain brands, so there is potentially some pull-through of end consumer demand on retailers, which decreases buyer power to some extent."[190] After analyzing bargaining power of buyers in tobacco industry, it can be concluded that it is moderate.

Figure 4.2. Drivers of buyers' bargaining power in global tobacco industry[191]



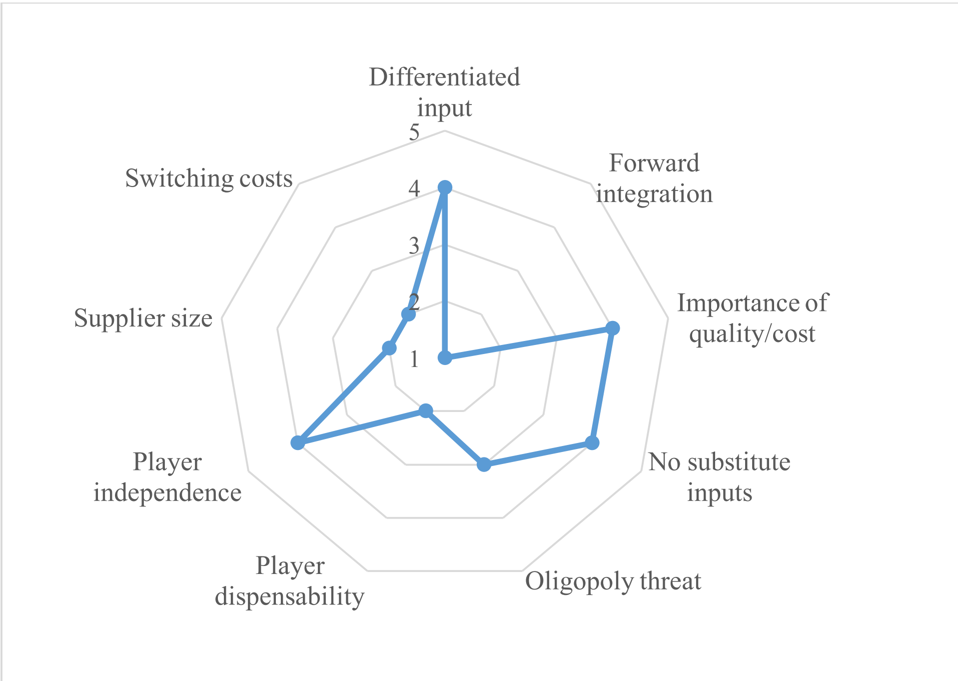
Source: MarketLine (2014.), *Industry Profile: Global Tobacco*, Datamonitor, London, pp. 15.

Tobacco is an agricultural product and therefore key suppliers in the tobacco industry include tobacco leaf farmers. Because of their smaller size, with many farms being family-run businesses, particularly those in developing countries these farmers lack power in the supply chain. "Further inputs to the industry include processing aids, humectants (which keep the tobacco moist and pliable), preservatives and brand-specific flavors. Companies such as

[189] MarketLine (2014.), *Industry Profile: Global Tobacco*, Datamonitor, London, pp. 15.
[190] MarketLine (2014.), *Industry Profile: Global Tobacco*, Datamonitor, London, pp. 15.
[191] Strong impact – 5; low impact 1.

Alcan Packaging, who are a leading global manufacturer of tobacco packaging, are also key suppliers in the tobacco industry. Alcan's inputs include in-line rotogravure printed hinge-lid blanks and soft packs. They are also the world's largest supplier of RYO (Roll Your Own) tobacco booklet covers, as well as printed OPP film (Oriented Polypropylene film), bundle wraps and tobacco pouches. Company Amcor is another global tobacco packaging supplier. Due to the relative size of these suppliers, their respective influence over the market is increased, although this may become weaker in the wake of efforts to introduce plain packaging for cigarettes in countries such as Australia, where it was introduced in December 2012. There are limited alternative raw materials in this market, so players are unlikely to switch a supplier, which increases bargaining power of supplier."[192] After analyzing bargaining power of suppliers in tobacco industry, it can be concluded that the bargaining power of suppliers is moderate.

Figure 4.3. Drivers of suppliers' bargaining power in global tobacco industry



Source: MarketLine (2014.), *Industry Profile: Global Tobacco*, Datamonitor, London, pp. 16.

Tobacco industry is very concentrated in many countries, and has strong existing brands which make it very difficult for a new player to enter the industry. That dominance of existing brands is notable, with leading players such as Philip Morris International (whose brands include Marlboro and L&M) and Japan Tobacco (whose brands include: Camel, Winston,

[192] MarketLine (2014.), *Industry Profile: Global Tobacco*, Datamonitor, London, pp. 16.

Silk Cut etc.) having presence in over 130 countries worldwide. Besides, retailers may be unwilling to stock products of an entirely new and unproven brand because shelf-space in retail outlets is finite. “Increased pressures directed to smoking also come from government regulations and legislative framework. In the number of markets prohibition on smoking in public places was introduced as well as tighten age restrictions which also represent barrier for new entrants. Therefore, current tobacco control strategies seek primarily to decrease the demand for cigarettes through measures that encourage individuals to adopt healthier behaviors, thus raising entry barriers. Although there are large variations to the extent of policies within specific markets, they remain a global influence as many countries follow the examples of early adopters. Furthermore, there are restrictions on the advertisement of tobacco products in many markets, which makes it increasingly difficult for new entrants to create brand awareness.”[193] The difficulty for new entrants of creating initial brand awareness will also be intensified should plain packaging become the norm in more markets in the coming years. The likelihood of new entrants is dramatically hindered by these factors but steady market growth may encourage new entrants in the global tobacco industry.[194] Therefore, it can be concluded that there is a weak threat from new entrants in the global industry.

There are a wide range of substitutes for tobacco, for example herbal cigarettes, nicotine gums and nicotine patches. Due to the health implications associated with smoking (e.g. increased risk of lung cancer, heart disease etc.) benefits of substituting tobacco products for alternate non-durable consumer goods are especially notable largely. “Because of the addictive quality of nicotine present in tobacco products, many smokers who want to quit, attempt to do so by substituting tobacco products for products such as nicotine gum, or patches. These products fulfill the consumer's need for nicotine without the harmful effects of inhaling smoke. Unlike tobacco products, which face restrictions on advertising in many markets, nicotine replacement products are highly promoted through a range of media.”[195]

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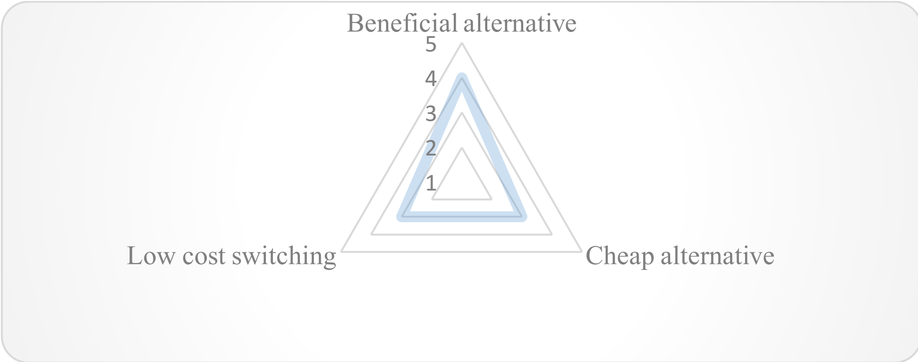
[193] MarketLine (2014.), *Industry Profile: Global Tobacco*, Datamonitor, London, pp. 17.
[194] MarketLine (2014.), *Industry Profile: Global Tobacco*, Datamonitor, London, pp. 17.
[195] MarketLine (2014.), *Industry Profile: Global Tobacco*, Datamonitor, London, pp. 18.

Figure 4.4. Factors influencing the threats of substitutes in global tobacco industry



Source: MarketLine (2014.), *Industry Profile: Global Tobacco*, Datamonitor, London, pp. 18.

An increasingly popular alternative to tobacco products which replicate the sensation of smoking and deliver to the user a small dose of nicotine that can satiate cravings, are electronic cigarettes or e-cigs. As their popularity increases, the threat they pose to the tobacco market correspondingly increases. However, some countries are looking to regulate electronic cigarettes and nicotine replacement products in order to ensure the quality and safety of these substitutes, which could serve to reduce the threat of substitutes.[196] After observing the threat of substitutes in tobacco industry it can be concluded that there is a moderate threat from substitutes.

The top four players in the global tobacco industry China National Tobacco Corporation, Philip Morris International, British American Tobacco and the Altria Group account for nearly two thirds of the market, with the size and financial muscle of these players intensifying competition. While there is a degree of differentiation in terms of products such as cigars and cigarillos, loose tobacco, and chewing tobacco, these options account for less than 14% of the market, with cigarettes making up the rest. The degree of product differentiation amongst cigarette brands is minimal, and that may be further reduced if the imposition of standardized plain packaging became commonplace. The effect of this would be to greatly increase rivalry, as the impact of premium brands is undermined.[197]

[196] MarketLine (2014.), *Industry Profile: Global Tobacco*, Datamonitor, London, pp. 18.
[197] MarketLine (2014.), *Industry Profile: Global Tobacco*, Datamonitor, London, pp. 19.

Figure 4.5. Drivers of the degree of rivalry in global tobacco industry

Source MarketLine (2014.), *Industry Profile: Global Tobacco*, Datamonitor, London, pp. 19.

Few major players, in order to respond to degree of rivalry, have started to explore the option of entering other areas of high growth, such as the electronic cigarette market. For example, British American Tobacco has set up a company called Nicoventures which released Vype e-cigarettes in 2013.[198] Major players diversifying into the e-cig market may alleviate some of this rivalry, as well as provide a level of security against the risk posed by substitutes. One threat that may prove more difficult to combat is that posed by illicit tobacco sales. According to the World Health Organization (WHO), the illicit market accounts for one in ten cigarettes consumed globally (around 600 billion cigarettes), with this lost market share increasing rivalry across the industry.[199] After analyzing rivalry among existing firms in tobacco industry it can be concluded that the rivalry is moderate.

4.2. Analysis of leading corporations in global tobacco industry

Leading companies in global tobacco industry are China National Tobacco Corporation, Philip Morris International, Altria Group Inc., British American Tobacco and Japan Tobacco. Their business characteristics as well as key financial indicators in period 2010-2014 are shown and analyzed in following paragraphs.

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[198] MarketLine (2014.), *Industry Profile: Global Tobacco*, Datamonitor, London, pp. 19.
[199] MarketLine (2014.), *Industry Profile: Global Tobacco*, Datamonitor, London, pp. 19.

China National Tobacco Corporation (CNTC), founded in 1982 and headquartered in Beijing, is a state-owned company engaged in the manufacture and sale of tobacco products in the Chinese and foreign markets. “The China National Tobacco Corp., which serves China’s 300 million smokers, is by far the largest cigarette maker in the world. In 2013 it manufactured about 2.5 trillion cigarettes. Its next largest competitor, Philip Morris International, produced 880 billion. In terms of market share, China National is bigger than its next five competitors combined; its growing sales have accounted for a net increase in global production, even as volume at its competitors has fallen.”[200] In its domestic market of China, China Tobacco has a virtual monopoly, producing and owning a portfolio of over 900 brands, of which Hongtashan is the company’s key cigarette brand.[201] The company, through a partnership agreement with Philip Morris, produces and sells Marlboro branded tobacco products in the Chinese market. China Tobacco also markets its own brands, such as RGD, Harmony and Dubliss, through Philip Morris in overseas markets including Central Europe, Eastern Europe and Latin America. It also produces and markets foreign brands such as 555 (British American Tobacco plc), Kool (R.J. Reynolds Tobacco Company), Camel (R.J. Reynolds Tobacco Company) and Lucky Strike (American Tobacco Company), in the Chinese market through license agreements with the respective manufacturers. As a government-owned entity, China National Tobacco Corporation is not legally obliged to release its financial results.[202]

Philip Morris International Inc. (PMI) is an international tobacco company headquartered in New York with more than 82.000 employees. The company, along with its subsidiaries, is engaged in the manufacturing and sale of cigarettes and other tobacco products in markets outside of the US. “In 2014, PMI held an estimated 15.5% share of the total international cigarette market outside of the United States, or 28.5% excluding the People’s Republic of China and the United States.”[203] The company operates its business through four segments, which are organized and managed by geographic region: European Union (EU), Asia, Eastern

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[200] Source: http://www.bloomberg.com/news/articles/2014-12-12/the-chinese-government-is-getting-rich-selling-cigarettes (21.06.2016.)

[201] “China National manufactures cigarettes in about 100 factories across the country, and uses its earnings to invest in banks, luxury hotels, a hydroelectric plant, a golf course, and even drug makers. Most of its money goes to its owner, the Chinese government; the tobacco industry accounts for about 7 percent of the state’s revenue each year, and China National controls as much as 98 percent of the market. The industry in China employs more than 500,000 Chinese”. Source: http://www.bloomberg.com/news/articles/2014-12-12/the-chinese-government-is-getting-rich-selling-cigarettes (19.06.2016.).

[202] MarketLine (2015.), *Industry Profile: Global Tobacco*, Datamonitor, London, pp. 27.

[203] Source: http://www.pmi.com/eng/about_us/company_overview/pages/company_overview.aspx (19.06.2016.).

Europe, Middle East, Africa, Latin America and Canada. The EU region covers all EU countries except for Slovenia, Bulgaria and Romania. PMI's key brands include Marlboro, Merit, Parliament, Virginia Slims, L&M, Chesterfield, Bond Street, Lark, Muratti, Next, Philip Morris, Red & White, Number 7, and other. The company uses four types of distribution: direct sales and distribution, "whereby it distributes directly to retailers; distribution through single independent distributors (with responsibility for a single market); exclusive zonified distribution, where distributors have an exclusive territory within a country; and distribution through wholesalers. Besides these, the company also directly services key accounts, including gas stations, retail chains and supermarkets in many countries."[204] Key financial indicators of PMI in period 2010-2014 as well as profitability margins are presented in tables 4.2. and 4.3.

Table 4.2. Key financial indicators of PMI in period 2010-2014

PMI - million USD	2010	2011	2012	2013	2014
Revenues	27.208	31.097	31.377	31.217	29.767
EBITDA	12.132	14.325	14.744	14.528	12.709
EBIT	11.200	13.332	13.846	13.515	11.702
Net income	7.259	8.591	8.800	8.576	7.493

Source: http://financials.morningstar.com/ratios/r.html?t=PM&region=usa&culture=en-US (20.06.2016.).

Table 4.3. Profitability margins of PMI in period 2010-2014

PMI	2010	2011	2012	2013	2014
EBITDA margin %	44,59%	46,07%	46,99%	46,54%	42,69%
EBIT margin %	41,16%	42,87%	44,13%	43,29%	39,31%
Net margin %	26,68%	27,63%	28,05%	27,47%	25,17%

Source: Author.

Altria Group, Inc. is a "multinational holding company with more than 9.000 employees, headquartered in Henrico County, Virginia, United States. Altria Group has business interests in companies operating in the tobacco, alcohol and financial services sectors. The company primarily operates in the US. Altria is the parent company of Philip Morris USA, and Philip Morris International was spun off in 2008."[205] The tobacco sector is comprised of cigarettes manufactured and sold by Altria's tobacco division Philip Morris USA Inc. (PM USA), it also includes machine-made cigars and pipe tobacco manufactured and sold by John Middleton. PM USA is the largest cigarette company in the US. It manufactures and sells cigarettes and certain smokeless products under a portfolio of well-known brands such as "Marlboro, Basic,

[204] MarketLine (2014.), *Industry Profile: Global Tobacco*, Datamonitor, London, pp. 28.
[205] Source: http://www.altria.com/About-Altria/Our-Heritage/Pages/default.aspx?src=topnav (20.06.2016.).

Benson & Hedges, Cambridge, Chesterfield, Commander, Dave's, English Ovals, L&M, Lark, Merit, Parliament, Players, Saratoga and Virginia Slims."[206] The cigars manufactured by John Middleton are marketed under brands such as Black & Mild, Middleton's Cherry Blend, Gold & Mild and Prince Albert. The subsidiary also markets pipe-tobacco under brands including Apple, Carter Hall, Black & Mild, Middleton's Cherry Blend, Prince Albert, Gold & Mild, Kentucky Club, Royal Comfort, Sugar Barrel and Walnut. The company operates its smokeless products segment through the U.S. Smokeless Tobacco Company LLC (USSTC) subsidiary, which manufactures moist smokeless products such as chewing tobacco. USSTC's portfolio comprises premium brands such as Copenhagen and Skoal, value brands including Red Seal and Husky, and Marlboro Snus. A majority of the smokeless tobacco products are manufactured and sold to customers in the US.[207] Key financial indicators of Altria in period 2010-2014 as well as profitability margins are presented in tables 4.4. and 4.5.

Table 4.4. Key financial indicators of Altria Group in period 2010-2014

Altria Group - million USD	2010	2011	2012	2013	2014
Sales	16.892	16.619	17.500	17.663	17.945
EBITDA	6.850	7.055	7.830	8.207	8.839
EBIT	6.228	6.068	7.253	8.084	7.620
Net income	3.905	3.390	4.180	4.535	5.070

Source: http://financials.morningstar.com/ratios/r.html?t=XBER:JAT&region=deu&culture=en-US (21.6.2016.).

Table 4.5. Profitability margins of Altria Group in period 2010-2014

Altria Group	2010	2011	2012	2013	2014
EBITDA margin %	40,55%	42,45%	44,74%	46,46%	49,26%
EBIT margin %	36,87%	36,51%	41,45%	45,77%	42,46%
Net margin %	23,12%	20,40%	23,89%	25,68%	28,25%

Source: Author.

British American Tobacco p.l.c. (BAT) is an international tobacco group engaged in the sale of cigarettes, cigars, smokeless snus and other tobacco products. BAT is headquartered in London, United Kingdom, with more than 57.500 employees. When American Tobacco Company and Imperial Tobacco Company form UK formed joint venture in 1902 BAT was founded.[208]

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[206] Source: http://www.altria.com/our-companies/philipmorrisusa/our-products-and-ingredients/Pages/default.aspx (21.06.2016.).
[207] MarketLine (2015.), *Industry Profile: Global Tobacco*, Datamonitor, London, pp. 20.
[208] Source: http://www.bat.com/group/sites/UK__9D9KCY.nsf/vwPagesWebLive/DO52ADGE (21.06.2016.).

"BAT is present on more than 200 markets across the America, Western Europe, Asia-Pacific, and Eastern Europe, and the Middle East and Africa through a large number of subsidiaries and associate companies. The company owns a portfolio of more than 200 brands. Its leading international brands, called the Global Drive Brands (GDBs), include Dunhill, Kent, Rothmans, Lucky Strike and Pall Mall."[209] Under the Dunhill brand, the company offers a range of premium and super-premium cigarettes and cigars across more than 110 countries. Kent is the company's largest premium brand and is sold in more than 80 markets. Additionally, the Lucky Strike brand is sold in more than 70 countries, while Pall Mall and Rothmans are sold across more than 100 markets and 60 markets, respectively, around the world. "The company distributes finished products to outlets throughout the world, including supermarkets, convenience stores, hotels, bars, restaurants, cafes, tobacco shops and duty free shops."[210] In addition to these, the company also operates through two principal associates, namely Reynolds American in the US and ITC in India. Reynolds American is a producer and marketer of tobacco and related products. ITC is an Indian conglomerate company with a presence in several consumer and hospitality industries, such as fast moving consumer goods including tobacco, agri-business, paperboard, paper and packaging, and the hotels industry.[211] Since year 2000 BAT was engaged in several M&A processes. In table 4.6. key financial indicators of BAT are presented, and profitability margins are presented in table 4.7.

Table 4.6. Key financial indicators of BAT in period 2010-2014

BAT - million GBP	2010	2011	2012	2013	2014
Revenues	14,883	15,399	15,190	15,260	13,971
EBITDA	5,475	6,014	6,207	6,890	5,950
EBIT	4,318	4,721	5,412	5,526	4,546
Net income	2,879	3,095	3,841	3,904	3,115

Source: http://financials.morningstar.com/ratios/r.html?t=BTI&region=usa&culture=en-US (21.06.016).

Table 4.7. Profitability margins of BAT in period 2010-2014

BAT	2010	2011	2012	2013	2014
EBITDA margin %	36,79%	39,05%	40,86%	45,15%	42,59%
EBIT margin %	29,01%	30,66%	35,63%	36,21%	32,54%
Net margin %	19,34%	20,10%	25,29%	25,58%	22,30%

Source: Author.

[209] MarketLine (2015.), *Industry Profile: Global Tobacco*, Datamonitor, London, pp. 23.
[210] MarketLine (2015.), *Industry Profile: Global Tobacco*, Datamonitor, London, pp. 23.
[211] MarketLine (2015.), *Industry Profile: Global Tobacco*, Datamonitor, London, pp. 23.

Japan Tobacco International **(JTI)** is a leading international tobacco company. JT sells its products in over 120 countries including Canada, the Netherlands, Switzerland, France, Germany, Russia, Ukraine, the Middle East and Africa. JTI has headquarters in Geneva, Switzerland, and more than 26,000 employees. "The company was created in 1999 when Japan Tobacco Inc (JT), their parent company, purchased the non-US operations of the multinational R. J. Reynolds for 7.8 billion USD. At the time, the acquisition of R. J. Reynolds International (RJRI) was the largest overseas acquisition ever made by a Japanese company."[212] Further acquisition of UK-based Gallaher in 2007 nearly for 9.4 billion GBP doubled the size of JTI.[213] JTI sells tobacco products under various brands including Winston, Camel, Mevius (formerly Mild Seven), Benson & Hedges, Silk Cut, LD, Sobranie and Glamour. JTI operates factories in 28 locations and other business facilities in around 70 locations around the world. The Japanese domestic tobacco segment is engaged in the manufacture and sale of tobacco products in domestic areas including duty-free retail stores across Japan and in the markets of China, Hong Kong and Macau. The key brands of the segment include Mevius, Seven Stars, echo and Caster Mild.[214] Key financial indicators of JTI are presented in table 4.8., and profitability margins are presented in table 4.9.

Table 4.8. Key financial indicators of JTI in period 2010-2014

JTI - million JPY	2010	2011	2012	2013	2014
Revenues	6.134.695	6.194.554	2.033.825	2.120.196	2.399.841
EBITDA	532.363	510.315	583.628	636.156	777.736
EBIT	296.505	328.681	408.622	532.360	648.260
Net income	138.448	144.962	320.883	343.612	427.987

Source: http://financials.morningstar.com/ratios/r.html?t=XBER:JAT&region=deu&culture=en-US (21.06.2016.).

Table 4.9. Profitability margins of JTI in period 2010-2014

JTI	2010	2011	2012	2013	2014
EBITDA margin %	8,68%	8,24%	28,70%	30,00%	32,41%
EBIT margin %	4,83%	5,31%	20,09%	25,11%	27,01%
Net margin %	2,26%	2,34%	15,78%	16,21%	17,83%

Source: Author.

When observing profitability margins of leading companies in global tobacco industry it can be concluded that industry has high steady profitability margins, and that in 2014 Altria Group had highest profitability margins compared to other competitors.

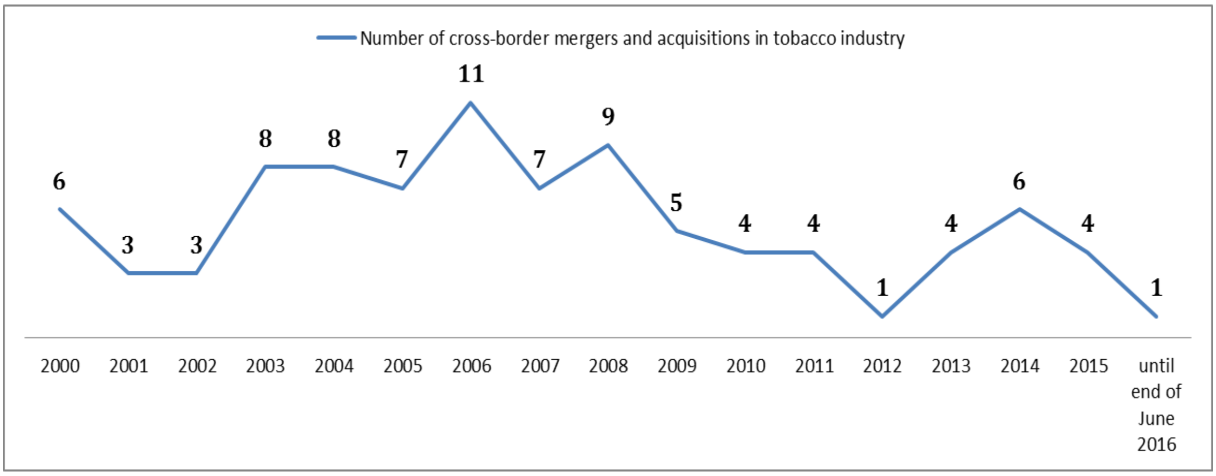
212 Source: http://www.jti.com/our-company/jti-at-a-glance/ (21.06.2016.).
213 Source: http://www.jti.com/our-company/jti-at-a-glance/ (21.06.2016.).
214 Source: http://www.jt.com/investors/results/annual_report/ (21.06.2016.).

4.3. Cross-border mergers and acquisitions in global tobacco industry

In period from 2000 until the end of June 2016, 115 transactions occurred in global tobacco industry, and 78% of them (total of 91 transactions) were characterized as cross-border. All of the following analysis of cross-border mergers and acquisitions focuses on transaction whose value was more than 5 million USD and all data was gathered from Mergermarket database.

The following figure displays the number of cross-border transactions per year. Evidently these transactions are very sensitive to the global economic trends; consequently decline in cross-border activities in global tobacco industry can be seen after the global financial and economic crisis that started in 2007.

Figure 4.6. Number of cross-border mergers and acquisitions per year, from 2000 until the end of June 2016



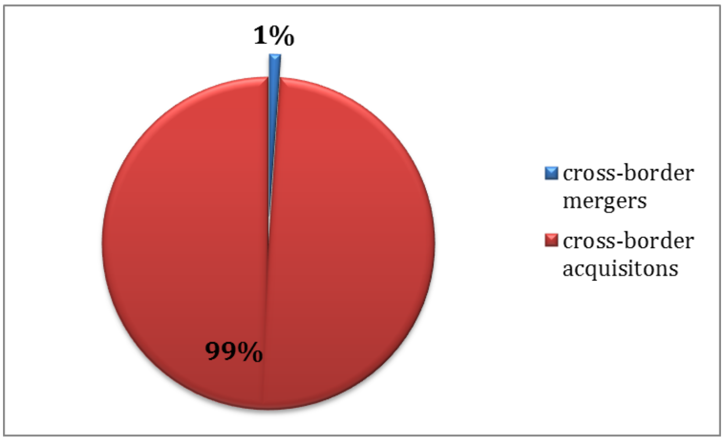
Source: www.mergermarket.com (22.06.2016.).

To this point in 2016 one transaction was completed. Japan Tobacco Inc. has signed an agreement to acquire non US-operations of Natural American Spirit from Reynolds American, Inc. Japan Tobacco Inc. paid 4,466 million EUR for the non US-operations of Natural American Spirit. The transaction includes Natural American Spirit's international companies that distribute and market the brand outside the United States and its brand name and associated trademarks.

As illustrated in the following figure, among all these 91 transactions from 2000 until the end of June 2016, only one of them was merger, and 90 were acquisitions. R. J. Reynolds Tobacco

Company, the US tobacco group and subsidiary of R. J. Reynolds Holdings, Inc., merged with Brown & Williamson (B & W), the US tobacco business of British American Tobacco Plc (BAT), and created a new public holding company, Reynolds American Inc., through a one-for-one exchange of stock in the new company. Reynolds American got approximately 150m shares outstanding and under the terms of the agreement BAT received 42% of Reynolds American with Reynolds' shareholders retaining a 58% stake. As part of the agreement BAT is not supposed to increase its holding above 42% for at least ten years. Reynolds American acquired Lane, BAT's US smoking tobacco and cigar business, for USD 400m in cash. The transaction included the transfer of all of B & W's Master Settlement Agreement liabilities to Reynolds American as well as the corresponding cash balance, which averages USD 750m over the course of the year, to cover previously accrued payment obligations. This indemnified B & W for all existing and any future litigation relating to its US business. In addition, the contributed assets of B & W included in the agreement were debt-free. The new board of Reynolds American was consisted of 13 members, including six directors from the existing Reynolds board and five directors designated by BAT. Combining the two businesses provided increased security in the challenging US market and enabled an enhancement to earnings through cost saving synergies. Completion of the transaction was in mid-year 2004.

Figure 4.7. Type of cross-border transactions from 2000 until the end of June 2016



Source: www.mergermarket.com (22.06.2016.).

In 2015 four transactions have been completed and the following table provides basic information regarding these deals. Among these transactions is also acquisition of Croatian tobacco company TDR d.o.o. by British American Tobacco Plc. Two transactions were transatlantic with US targets and sellers and European bidders. Furthermore, it is important to indicate that only one of these transactions was public (Imperial Tobacco Group Plc.

acquisition of Winston, Maverick, Kool and Salem cigarette brands from Reynolds American Inc.)

Table 4.10. Cross-border mergers and acquisitions in 2015

	Target company	Bidder	Home country of the target	Home country of the bidder	Type of transaction	Value (mil EUR)
1.	Parodi Holdings LLC (80% stake)	Manifatture Sigaro Toscano Spa	USA	Italy	Acquisition, recommended, cross-border, transatlantic, private	5
2.	Imperial Tobacco Group Plc. (fine cut and pipe tobacco brands business)	Mac Baren Tobacco Company A/S	UK	Denmark	Acquisition, recommended, cross-border, private	n.a.
3.	TDR d.o.o.	British American Tobacco Plc	Croatia	UK	Acquisition, recommended, cross-border, private	505
4.	Reynolds American Inc (Winston, Maverick, Kool, Salem and blu cigarette brands)	Imperial Tobacco Group Plc	USA	UK	Acquisition, recommended, cross-border, transatlantic, public	5.233

Source: www.mergermarket.com (22.06.2016.).

The objects of the following analysis are these transactions from the Table 4.10. that were completed in 2015, while the British American Tobacco Plc acquisition of Croatian TDR d.o.o. will be analyzed in the chapter 5.

Manifatture Sigaro Toscano Spa, the Italy-based producer of cigar, and a subsidiary of Officine Maccaferri SpA, the Italy-based provider of geotechnical and soil erosion control solutions to the construction industry, acquired 80% stake in Parodi Holdings LLC, the US-based cigar manufacturer, from Tannhauser Associates, Inc., the US-based company engaged in manufacturing of cigars, for an undisclosed consideration. The acquisition of Parodi enabled Manifatture to expand in new markets.

Mac Baren Tobacco Company A/S, a Denmark-based tobacco company and a subsidiary of Halberg A/S, a Denmark-based family owned company which, through its subsidiaries, operates hotels, engages in the production of tobacco, and invests in the real estate properties, acquired the fine cut and pipe tobacco brands business of Imperial Tobacco Group Plc, the listed UK-based tobacco group, for an undisclosed consideration. The sale was in line with Imperial Tobacco's strategy to divest its non-core pipe business and focus on its bigger global cigarette and fine cut brands. The transaction was expected to increase Mac Baren Tobacco's cigarettes production by 25-30% and also to create additional job opportunities at its factory in Svendborg town. The increased production volume enhanced the ongoing automation and efficiency in Mac Baren Tobacco's production process, thereby giving it a competitive edge in the market. The acquired brands were expected to increase production by 500 tons of tobacco and revenue by DKK 100m (EUR 13.4m) annually.

Imperial Tobacco Group Plc acquired the Winston, Maverick, Kool, Salem and blu cigarette brands from Reynolds American Inc. Reynolds American Inc, the listed US-based company headquartered in Winston-Salem, North Carolina, is a manufacturer of tobacco products. Imperial Tobacco Group Plc, the listed UK-based headquartered in Bristol, Somerset, is a tobacco group. The acquisition was in line with Imperial's strategy to invest into growth brands and growth markets. The acquisition facilitated Imperial to enhance its US business and to generate a robust foothold in world's largest accessible profit pool. The enlarged US business formed approximately 24% of Imperials' tobacco net revenues. The acquisition of the e-cigarette brand, blu combined with Imperial's e-vapour know-how provided it with leadership in the market. The transaction increased shareholders' worth and enhanced Imperials' footprint in the market. The transaction delivered both a Return on Invested Capital at over 10% in its first year, in excess of Imperial's weighted average cost of capital and enhanced EPS in the first year following the completion. The enlarged US business of Imperial is expected to have a market share of 10% of the US cigarette market. Imperial plans to introduce the blu e-cigarette brand in the international market.

Similarly in 2014 there were six transactions and the following table provides basic information regarding these deals. Five transactions were transatlantic with European targets and sellers and US bidders. Furthermore, it is important to indicate that all transactions were private (non-public). Value of these transactions in 2014 is significantly inferior in comparison to the values of transactions in 2015. Especially active in 2004 was Victory Electronic Cigarettes Corporation, Ltd. the listed US-based company with acquisition of three targets (Ten Motives Limited, Must Have Limited and The VAPESTICK Group Limited).

Table 4.11. Cross-border mergers and acquisitions in 2014

	Target company	*Bidder*	*Home country of the target*	*Home country of the bidder*	*Type of transaction*	*Value (mil EUR)*
1.	Nicocigs Limited	Philip Morris International Inc	UK	USA	Acquisition, recommended, cross-border, transatlantic, private	76
2.	Ten Motives Limited	Victory Electronic Cigarettes Corporation, Ltd.	UK	USA	Acquisition, recommended, cross-border, transatlantic, private	76
3.	Must Have Limited	Victory Electronic Cigarettes Corporation, Ltd.	UK	USA	Acquisition, recommended, cross-border, transatlantic, private	27
4.	Oz-Ege Tutun Sanayi Ve Ticaret A.S. (Tobacco Storage and Processing Factory) (50% Stake)	Alliance One International Inc	Turkey	USA	Acquisition, recommended, cross-border, transatlantic, private	n.a.
5.	The VAPESTICK Group Limited	Victory Electronic Cigarettes Corporation, Ltd.	UK	USA	Acquisition, recommended, cross-border, transatlantic, private	51
6.	Verellen NV	Scandinavian Tobacco Group A/S	Belgium	Denmark	Acquisition, recommended, cross-border, private	n.a.

Source: www.mergermarket.com (23.06.2016.).

In the focus of following analysis are these transactions from the Table 4.11. that were completed in 2014. Philip Morris International Inc, the listed US-based tobacco company involved in the manufacture and distribution of cigarettes, acquired Nicocigs Limited, the UK-based manufacturer and supplier of electronic smoking products, for a total purchase price of USD 103m. Nicocigs had workforce of 40 employees and distributed to 20,000 stores in UK. The acquisition enhanced PMI's presence in UK market and enhanced its distribution arrangements in the U.K. Scandinavian Tobacco Group A/S, the Denmark-based manufacturer and distributor of cigars and smoking tobacco, acquired Verellen NV, the Belgium-based manufacturer and distributor of cigars and cigarillos, from Verellen Family, the Belgium-based family which owns and operates Verellen NV, for an undisclosed consideration. Verellen NV had a workforce of 125 employees. Verellen produced 185 million cigars yearly at its facility in Wuustwezel, Belgium. The acquisition was in line with

Scandinavian's strategy to expand in the sector, thereby enhancing its presence in European markets.

Victory Electronic Cigarettes Corporation, the listed US-based company engaged in manufacturing and distribution of electronic cigarettes and related accessories, acquired Must Have Limited doing business as VIP Electronic Cigarette, the UK-based company that designed and manufactured electronic cigarettes, for a total consideration of about USD 52m. With this transaction Victory Electronic intended to invest in expanding the distribution model and product portfolio of VIP. The acquisition of VIP was in line with Victory's existing business and the transaction was expected to have a material impact on both revenue and profit of VIP. The transaction strengthened the current market position and expanded the current market reach of Victory Electronic Cigarettes. Following the transaction, VIP operated as a wholly owned subsidiary of Victory Electronic Cigarettes. The management team and employees of VIP remained in the business. Alliance One Tutun A.S., the Turkey-based producer and exporter of tobacco, and a subsidiary of Alliance One International Inc, the US-based leaf tobacco merchant serving manufacturers of cigarettes and other consumer tobacco products, acquired 50% shares in Oryantal Tütün Paketleme Sanayi A.S., for processing and storage of tobacco. The transaction was in line with Oz-Ege Tutun Sanayi's strategy to enhance the quality of tobacco products at reasonable price. The transaction was in line with Alliance One's approach to expand its foot prints in Turkish markets.

Victory Electronic Cigarettes Corporation also acquired The VAPESTICK Group Limited, the UK based company engaged in manufacturing and distributing electronic cigarettes and related accessories, for a consideration of USD 70m. Under the terms of agreement, USD 64.2m were paid in cash and USD 5.7m were paid in equity. The acquisition was also in line with ongoing global market consolidation strategy of Victory. The transaction was expected to improve cost competitiveness and rapidly accelerate its growth. The transaction provided strength to Victory and substantial value for the shareholders of both companies. The acquisition significantly expanded management bandwidth and enabled accelerated growth of both operations.

In terms of value of transactions, the following table presents data regarding 10 largest transactions from 2000 until now and among them is also the transaction that was recorded as the only one merger in this period in tobacco industry. Since these transactions are largest in terms of deal value, it is expected that proportion of the public transactions will be significant and evidently 60% of these transactions were public. Additionally, it is important to indicate that most of these transactions occurred prior to the global financial and economic crisis in 2007.

Table 4.12. The largest cross-border transactions from 2000 until the end of June 2016

	Target company	***Seller***	***Bidder***	***Type of transaction***	***Value (mil EUR)***	***Year***
1.	Altadis SA	n.a.	Imperial Tobacco Group Plc	Acquisition, recommended, cross-border, public	15.023	2007
2.	Gallaher Group plc	n.a.	Japan Tobacco	Acquisition, recommended, cross-border, public	14.549	2006
3.	Reynolds American Inc (Winston, Maverick, Kool, Salem and blu cigarette brands)	Reynolds American Inc	Imperial Tobacco Group Plc	Acquisition, recommended, cross-border, transatlantic, public	5.233	2015
4.	Reemtsma Cigarettenfabriken	Maxingvest AG	Imperial Tobacco Group	Acquisition, recommended, cross-border, public	5.189	2002
5.	US-operations of Natural American Spirit	Reynolds American, Inc.	Japan Tobacco Inc	Acquisition, recommended, cross-border, private	4.446	2016
6.	P T Hanjaya Mandala Sampoerna Tbk	n.a.	PT Philip Morris Indonesia	Acquisition, recommended, cross-border, public	3.803	2005
7.	Fiedler & Lundgren AB, House of Prince A/S, JL Tiedemanns Tobaksfabrik AS	Skandinavisk Tobakskompagni A/S	British American Tobacco (BAT)	Acquisition, recommended, cross-border, private	2.668	2008
8.	Ente Tabacchi Italiani S.p.A (ETI),	Government of Italy	British American Tobacco Plc (BAT)	Acquisition, recommended, cross-border, private	2.325	2003
9.	R. J. Reynolds Tobacco Company, the US tobacco group and subsidiary of R. J. Reynolds Holdings, Inc., agreed to merge with Brown & Williamson (B & W), the US tobacco business of British American Tobacco Plc (BAT), to create a new public holding company, Reynolds American Inc.			Merger, recommended, cross-border, transatlantic, public	2.213	2003
10.	CBHC Inc (Commonwealth Brands Inc)	Houchens Industries Inc	Imperial Tobacco Group plc	Acquisition, recommended, cross-border, transatlantic, private	1.457	2007

Source: www.mergermarket.com (23.06.2016.).

Following analysis is focused on these largest transactions from the Table 4.12., with third, fifth and ninth transaction already elaborated in the previous analysis. Imperial Tobacco Group plc, the UK listed tobacco company, launched an all cash public offer for the entire outstanding share capital of Altadis SA, the Spanish listed counterpart. The offer consideration was EUR 50 in cash for each Altadis share. Regarding the financing, "Citi, RBS, Lehman Brothers, Barclays and Banco Santander entered into an agreement with Imperial Tobacco to arrange and underwrite new bank debt facilities of EUR 13.5 billion for, amongst other uses, the provision of part of the necessary funding for the proposed acquisition, including fees and expenses, and to refinance certain of Imperial Tobacco's and Altadis' current debt facilities. Imperial Tobacco expected to benefit from disposals of non-core assets valued by Altadis at EUR 650m. Imperial Tobacco intended to maintain its dividend policy, increasing dividends broadly in line with underlying earnings growth with around a 50% payout ratio."[215]

Japan Tobacco acquired Gallaher Group plc, the UK-based international tobacco company. The offer was GBp 1140 in cash per Gallaher Group share. It represented a discount of -1.3% over Gallaher Group's share price of GBp 1150 on 14 December 2006, the last trading day prior to the announcement. It represented a premium of 15.6% over Gallaher Group's share price of GBp 986.5 on 5 December 2006, the last trading day prior to the confirmation. The transaction was funded by a combination of existing funds and additional debt financing. Since Gallaher operated in UK, Ireland, Austria, Sweden and Kazakhstan and Japan Tobacco operated in Japan, Taiwan, CIS, Spain, France, Italy and Iran, therefore the acquisition also allowed the two groups to combine their technological strengths and know-hows.

Imperial Tobacco Group, a UK based tobacco and cigarette company, acquired 90.1% of a privately held German counterpart, Reemtsma Cigarettenfabriken, for GBP 3,183m (EUR 5,221m) on a cash and debt free basis. The transaction valued Reemtsma at GBP 3,537m (EUR 5,800m). The acquisition provided access to the German and Eastern European markets for Imperial. The combined company was expected to obtain synergy cost savings of up to EUR 279m in fiscal year 2004. The EBITDA margin for Imperial was 44% compared to 19% for Reemtsma, providing opportunities for efficiency gains in the combined entity. Reemtsma

[215] Source: https://www.sec.gov/Archives/edgar/data/1072670/000110465907058080/a07-20840_1ex99d1.htm (23.06.2016.).

was also seen as one of the few remaining attractive targets for tobacco industry consolidation as it was not exposed the US litigation.

PT Philip Morris Indonesia, the Indonesian manufacturer of cigarette and an affiliate of Philip Morris International Inc (PMI), the listed Switzerland-based tobacco company, acquired P T Hanjaya Mandala Sampoerna Tbk (Sampoerna), the listed Indonesian cigarette manufacturer for a cash consideration of IDR 48tln (USD 5.12bn), including net debt of IDR 1.5tln (USD 160m). Under the terms of the agreement, PT Philip Morris Indonesia initially acquired a 40% stake from a number of principal Sampoerna shareholders at IDR 10,600 (USD 1.13) per share for a total consideration of IDR 18.6tln (USD 2bn) in cash. PMI then made a public offer for the remaining 60% of the shares at the same price of IDR 10,600 (USD 1.13) per share, increasing the total cash consideration of the deal by another IDR 29.4tln (USD 3.2bn). The transaction was financed through a bank credit facility arranged for PMI. The acquisition was expected to be accretive to the diluted EPS of PMI's ultimate holding company, the US-based Altria Group, in 2005. The purchase of Sampoerna enabled PMI to expand considerably in the rapidly growing Indonesian market for kretek cigarette. Furthermore, PMI intended to make additional investments in Sampoerna's distribution and manufacturing infrastructure.

British American Tobacco (BAT) acquired Fiedler & Lundgren AB, the Sweden based producer of snuff, House of Prince A/S, the Danish tobacco manufacturer, and JL Tiedemanns Tobaksfabrik AS, the Norway based tobacco manufacturer, from its Danish counterpart, Skandinavisk Tobakskompagni A/S (ST), for a total consideration of DKK 20,331m (USD 4,053.81m). Under the terms of the agreement, the consideration was satisfied in both cash and equity, whereby BAT paid DKK 11,384m (USD 2,269.86m) in cash and DKK 8,947m (USD 1,783.95m) worth of ST shares representing a 32.35% stake, which it already held. British American Tobacco estimated that the businesses to be acquired generated an EBITDA of DKK 1,812 million (USD 354.61m) in 2007. "ST's cigarettes were sold in around 40 markets. Prince, its premium brand, accounted for annual volumes of about 7bn cigarettes in 25 markets – the largest of which was in Scandinavia. Smaller markets included Germany, Greece and the Baltic states. The roll-your-own business to be acquired had sales equivalent to around 2bn cigarettes a year."[216] Three companies employed approximately 2,100 people, of which 730 were located in Denmark. During the last financial year, the companies'

[216] Source: http://www.bat.com/group/sites/UK__9D9KCY.nsf/vwlivelookupHomePage/HOME?opendocument (23.06.2016.).

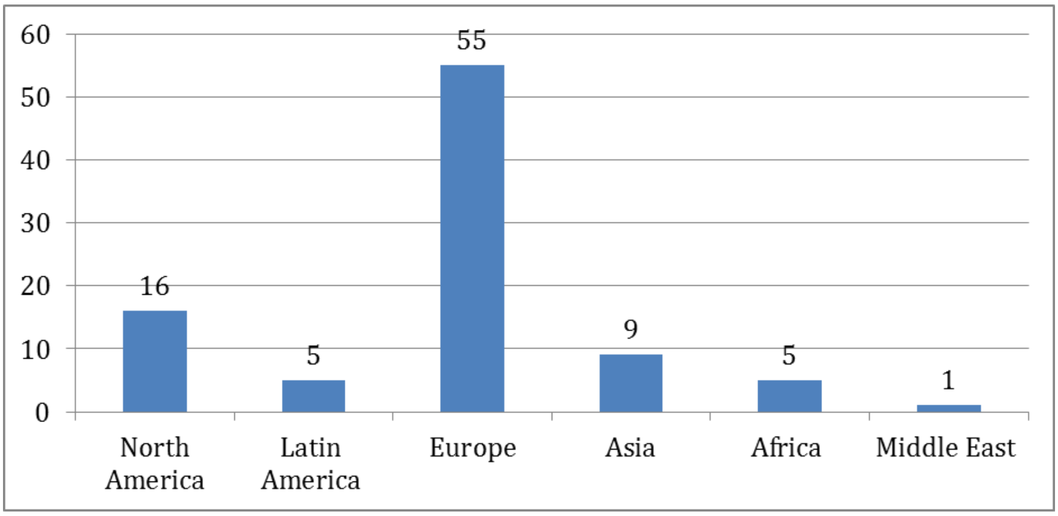
turnover was DKK 5.4bn (USD 1,06bn). The acquisition was in line with BAT's strategy of strengthening its market presence in Scandinavia and Poland.

British American Tobacco Plc (BAT) also acquired Ente Tabacchi Italiani S.p.A (ETI), its Italy based counterpart, from the Government of Italy, for EUR 2.325bn. BAT was the winning bidder in an auction process which had been carried out by the Italian government to maximise ETI's selling price. The acquisition enabled BAT to transform its presence in one of Europe's largest tobacco markets. The deal was funded from existing company resources.

Imperial Tobacco Group plc acquired CBHC Inc (Commonwealth Brands Inc), the US based cigarette maker, from Houchens Industries Inc, the US based owner and operator of supermarkets, groceries and convenience stores, for a consideration of USD 1.9bn. The consideration represented an EBITDA multiple of 10.9. The net cost of acquisition was USD 1.5bn after considering the net present value of tax benefits arising as a result of the acquisition. The transaction was funded by way of debt facilities. The returns from the transaction were expected to exceed the weighted average cost of capital of Imperial Tobacco in the first full year. The acquisition was expected to create significant value for the shareholders of Imperial Tobacco. It resulted in reduced annual costs of up to USD 20m. The deal was in line with the strategy of Imperial Tobacco to enter in the US markets. Commonwealth Brands generated USD 348m of revenues for the year ended 30 September 2006. It employed around 720 people and had an annual production capacity of 30bn cigarettes.

The following analysis refers to the geography of the target/seller company as well as to the geography of the bidder company. As illustrated in figure 4.8. most of the target/seller companies were European ones (60%), followed by North America (17,5%) and Asia (10%).

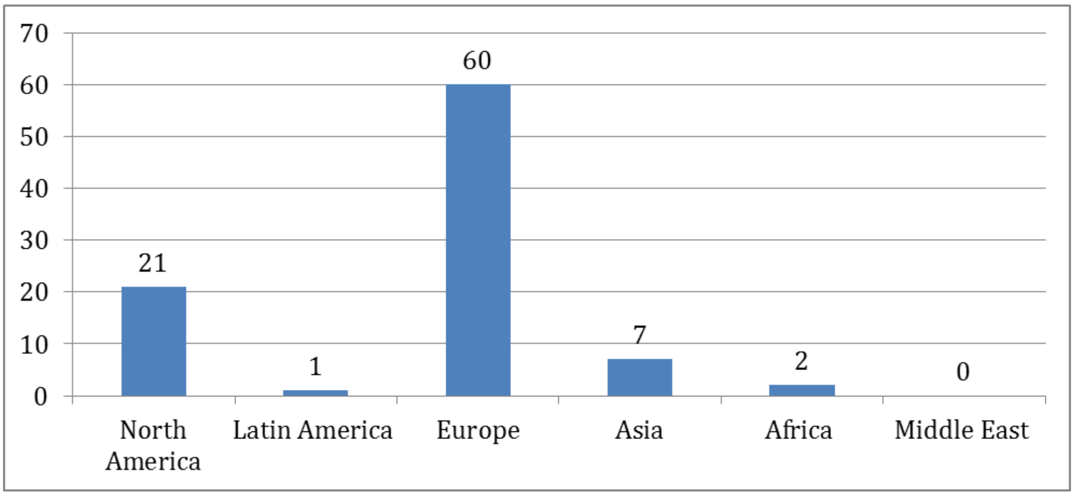
Figure 4.8. Geography of target/seller company



Source: www.mergermarket.com (24.06.2016.).

Regarding the geography of bidder company, as illustrated in figure 4.9. most of the bidder companies were European ones (66%), followed by North America (23%) and Asia (7,6%).

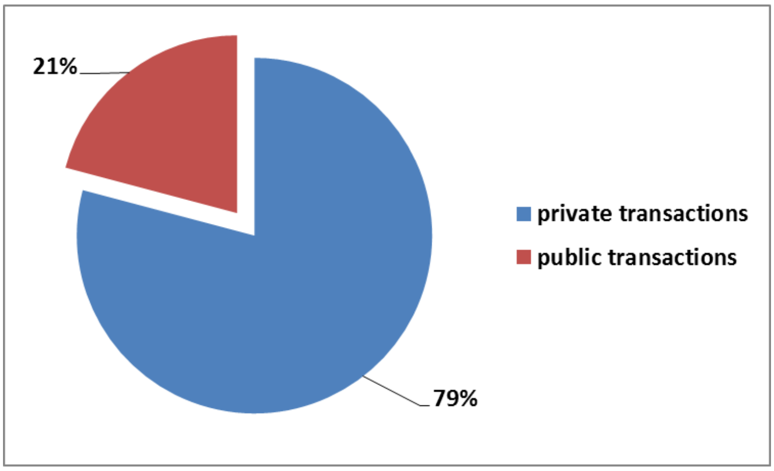
Figure 4.9. Geography of bidder company



Source: www.mergermarket.com (24.06.2016.).

Finally, the attention is put on character of cross-border mergers and acquisitions from 2000 until the end of June 2016 in terms of whether the transactions were private or public.

Figure 4.10. Proportions of private and public transactions



Source: www.mergermarket.com (24.06.2016.).

Proportions of private and public transactions are illustrated in figure 4.10. Private transactions with 79%, as expected, dominate the arena of cross-border mergers and acquisitions, even though the largest ones are public transactions.

5. EMPIRICAL RESEARCH OF CROSS-BORDER ACQUISITIONS IN TOBACCO INDUSTRY IN CROATIA

Main focus of this chapter is analysis of TDR's acquisition by BAT. After the main objectives of this research and methodology were explained, analysis of tobacco industry in Republic of Croatia was conducted, and detail analysis of acquisition of TDR by BAT was performed.

5.1. Objectives and methodology of the research

Objectives in this research were set in order to explain how and why BAT acquired TDR. One of the objectives was to assess profitability of TDR, and to analyze what caused the decrease in TDR's performance. Second important objective of this research was to examine whether sell off of TDR was prudent strategic decision for its shareholders. Third, and the most important objective, was to analyze if the price paid for TDR was satisfactory for all of its shareholders, and what would happen if TDR was sold at the beginning or during 2008. Based on the objectives in this research following hypothesis were set:

H1: Changes in TDR‘s profitability were caused by external factors (strong international competition and changing legislative framework)
H2: Sell off of TDR was prudent strategic decision for its shareholders instead of further internal developing of tobacco business
H3: Shareholders of TDR would be better off if TDR was acquired at the beginning of 2008 instead in 2015.

One of the most common research methods used in field of mergers and acquisitions, case study method, was used within this research to test hypothesis that were set. Case study refers to using different methods in order to analyze one or more selected cases with specific research problem. Case study usually focuses on research problems which are ample with information and observed characteristics, and analysis is holistic. As a research method, case study is selected when the main aim of the research is to examine how and why certain situations and events occurred. There are three types of case study:

- observing case study
- descriptive case study
- causal case study.[217]

In this master's thesis all types are combined because all relevant information related to BAT-TDR transaction are observed, described and causal interpretations are be made. Most case studies are qualitative in nature but researchers also use multi-method research which relies both on qualitative and quantitative data.[218] Multi-method research was also used in this thesis – quantitative data was used when analyzing performance of tobacco companies and qualitative data was used when examining how and why BAT acquired TDR.

In order to increase the quality of case study it is necessary to create research plan. That plan should be followed during collection of information, analysis and interpretation of information, and it allows inferences on cause-effect relations between observed variables. Case study plan was comprised of:

1. **Research objectives** – mainly directed to examining how and why certain events occurred (how and why TDR was acquired by BAT)
2. **Case study assumptions** – hypotheses were set in order to direct attention on what should be analyzed
3. **Unit of the case study** – refers to what is basic problem of the study (it can be person, event, entity, organization or program, and in this case it is BAT-TDR transaction)
4. **Connecting information and assumptions –** should be based on sound logic (e. g. connecting qualitative and quantitative information and comparing them with assumptions about BAT-TDR transaction…)
5. **Criteria for interpretation of findings –** even though criteria for interpretations is usually partially biased it should be based on objective indicators (e. g. tobacco industry averages, specific market conditions, EU membership of Croatia…).[219]

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[217] Verčić Tkalac, A., Sinčić Ćorić, D., Pološki Vokić, N. (2010.), *Priručnik za metodologiju istraživačkog rada: kako osmisliti, provesti i opisati znanstveno i stručno istraživanje,* MEP, Zagreb, pp. 94.
[218] Harland, T. (2014.), Learning about case study methodology to research higher education, *Higher Education Research & Development*, 33(6), pp. 1117.
[219] Verčić Tkalac, A., Sinčić Ćorić, D., Pološki Vokić, N. (2010.), *Priručnik za metodologiju istraživačkog rada: kako osmisliti, provesti i opisati znanstveno i stručno istraživanje,* MEP, Zagreb, pp. 95.

In order to obtain high quality findings thru case study the analysis should be based on theory, and it should encompass historical perspective of the case, and use several resources to get relevant information.[220] Therefore, in this case study recent theoretical findings in M&A field were analyzed as well as historical perspective of TDR and its development stages. Besides, one of the best M&A databases in the world - Mergermarket – was used to find and analyze transactions in tobacco industry in whole Europe, and Morningstar data base was used in order to compare financial performance of leading tobacco companies with financial performance of TDR.

5.2. Analysis of tobacco industry in Croatia

Leading player in Croatian tobacco industry for more than 20 years was Tvornica duhana Rovinj – TDR (Tobacco Factory Rovinj). TDR was founded in 1872 as a plant for cigarettes supply to officers of the Austro-Hungarian army. By the end of World War II TDR operated within the Austrian tobacco monopoly, and between the two World Wars TDR was part of the Italian tobacco monopoly. After World War II, the factory in Rovinj was equipped with new machines, which resulted in the expansion of product range and modernization of distribution network. In the eighties of the last century Ronhill was created, the most famous brand of TDR, and after the acquisition of the Zagreb Tobacco Factory in the nineties TDR become the leading company in the Croatian market of tobacco products. In January 2001, TDR founded its own tourist company called Adria Resorts (today Maistra), and in December 2003 Adris Group was founded, as a parent company in which TDR became the tobacco division. TDR also included in its business division companies like Hrvatski duhani and Istragrafika. Nowadays, TDR is vertically integrated company comprised of companies Hrvatski duhani, Istragrafika, Adista, and TDR's subsidiaries. Each of these companies has its own role in the process of growing, tobacco processing as well as manufacturing and distributing of tobacco products. TDR's core business is production and distribution of finished tobacco products, while Istragrafika produces packaging products for tobacco products. TDR's subsidiaries ensure the presence of TDR's products in major markets and take care of TDR's products distribution and communication with customers and business partners. The product portfolio

[220] Verčić Tkalac, A., Sinčić Ćorić, D., Pološki Vokić, N. (2010.), *Priručnik za metodologiju istraživačkog rada: kako osmisliti, provesti i opisati znanstveno i stručno istraživanje,* MEP, Zagreb, pp. 96.

of TDR today includes cigarette brands Ronhill, Walter Wolf, Largo, Columbus, York and MC. Ronhill is bestselling brand of TDR with 43,5% in total sales volume.[221]

Since its inception TDR has grown into a leading national and regional manufacturer and exporter of tobacco products. From 1992 to 2008 it has recorded a steady growth of the market share. After conquering Croatian market, a strong expansion to other markets in the region followed. TDR had leading position in Croatia with market share around 75% and in Bosnia and Herzegovina with market share around 38%. Market share in Montenegro was higher than 12%, it was 10% in Kosovo, 9% in Serbia and Macedonia, while TDR's market share in Slovenia was 4%. In 2013 TDR has built a factory in Iran in cooperation with leading Iranian tobacco manufacturer, Iranian Tobacco Company. That was an investment worth 30 million EUR (factory capacity is 6 billion cigarettes per year) which helped TDR to strongly position itself as one of the leading Croatian exporters, and TDR expanded its operations to the challenging market of Southwestern Asia. TDR exports its products to 15 markets. In addition to the Western Balkan countries, TDR exports its products even to Germany, Spain, Czech Republic, Italy, Austria, the United Arab Emirates, Bulgaria and Russia.[222]

In 2010 TDR has sold more than 13 billion cigarettes representing an increase of 4.4% compared to 2009.[223] Growth in sales volume did not follow the growth of sales revenue because TDR, despite of the increase in excise duty on all markets, took into consideration the economic situation and the growing crisis in the Republic of Croatia and made a decision on the minimum increase of the price of their products, thus reducing their own revenues and earnings. TDR's sales revenues in 2010 amounted to 214,1 million EUR and were by 6.05% lower than sales revenues in the 2009.[224] On October, 17th 2008 Croatian Parliament adopted the Law on the use of tobacco products. That law, in order to protect the health of citizens, defined the measures for reducing and limiting the use of tobacco products, the harmful ingredients of cigarettes, mandatory labels on tobacco product packaging, and preventive measures against smoking. Key financial indicators of TDR are presented in table 5.1.

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[221] Source: http://www.tdr.hr/o_tdr/tdr_sustav/index.html (11.07.2016.).
[222] Source: http://hr.seebiz.eu/industrija/tdr-otvorio-tvornicu-u-iranu/ar-72180/ (11.07.2016.).
[223] Source: http://liderpress.hr/tvrtke-i-trzista/poslovna-scena/tdr-i-istragrafika-postaju-bolne-tocke/ (12.07.2016.).
[224] Source: http://www.tdr.hr/o_tdr/tdr_regija.html (12.07.2016.).

Table 5.1. TDR's key performance indicators from 2007 to 2014

TDR - EUR	2007	2008	2009	2010	2011	2012	2013	2014
Revnues	**269.365.430**	265.914.156	231.184.068	217.193.027	206.887.813	195.717.080	159.577.227	**136.189.400**
EBITDA	**103.441.730**	105.861.321	85.372.426	62.837.000	58.126.800	55.884.253	39.757.133	**26.628.667**
EBIT	**91.669.028**	93.683.205	72.733.936	50.220.467	45.930.653	28.878.267	16.182.667	**15.520.467**
Net income	**73.209.301**	74.973.785	62.885.613	49.122.067	39.114.253	30.358.080	18.181.533	**16.178.613**

Source: http://www.poslovna.hr/subjekti.aspx?show=577256&tab=posl (12.07.2016.).

It is obvious when observing table 5.1. that TDR's business performance is characterized with negative trends from 2007. In 2007 TDR reached peak of it business performance with sales revenues of 269,3 million EUR, EBITDA (earnings before interest, tax, depreciation and amortization) of 103,4 million, EBIT (earnings before interest and tax) of 91,6 million, and net income of 73,2 million EUR. EBITDA margin in 2007 was 38,40%, EBIT margin was 34,03%, and net margin was 27,18%. In 2008 sales revenues decreased slightly by 1,28%, and all profit margins were similar compared with business performance in 2007. In 2009 sales revenues continued to deteriorate and equaled 231,1 million EUR and decreased for 13,06% compared to performance in 2008 but EBITDA and EBIT margins were 36,96% and 31,46% which is similar to the profitability levels in 2008 and 2007. Significant decrease of TDR's profitability occurred in 2010 when EBITDA and EBIT margins fell to 28,93% and 23,12% while sales revenues decreased for 6,05% and equaled 217,1 million EUR. The continuous decrease of key performance indicators was most obvious in 2014. At the end of 2014 sales revenues of TDR equaled 136,1 million EUR which is decrease for 49,44% when compared to sales revenues in 2007. EBITDA and EBIT also decreased for 74,26% and 83,07% in 2014 compared to 2007 while net income shrink for 77,90% in 2014 when compared to 2007. EBITDA, EBIT and net margins equaled 19,55%, 11,40% and 11,88% in 2014. All EBITDA margins of global tobacco leaders were higher than 40% in 2014 (TDR was at that level in 2007) and that is obvious indicator that TDR was performing way below industry average.

Besides the decrease in sales revenue which was a result of the constant increase of the excise duty, TDR's performance was highly affected by the strong pressure of competitors in the domestic market. Competitive companies like Philip Morris Zagreb, BAT Croatia, Zagreb Imperial Tobacco and JT International Zagreb increased their share in the Croatian tobacco market and continuously pressured TDR's performance. For example, Phillip Morris Zagreb had sales revenues of 182,6 million EUR in 2010 while in 2014 sales revenues reached 270,6 million EUR which is higher than TDR's revenues in 2007.[225] Furthermore, in one situation foreign competitors accused Croatian Ministry of Finance that it refuses to issue excise stamps for imported cigarettes, thereby preventing the supply of cigarettes in the Croatian market, all to favor TDR.[226] In addition, the Administrative Court in Zagreb confirmed the conclusion of the Croatian Competition Agency from January 12th, 2012 which rejected an initiative proposed by Japan Tobacco International for initiating procedure in order to determine abuse of dominant position by the TDR. In 2011, BAT Croatia initiated the procedure for determining the distortion of competition against TDR. Namely, BAT charged TDR to Croatian Competition Agency (CCA) for abuse of dominant position. According to BAT's allegations TDR used its contracts with large retailers to prevent BAT from entering their retail shelves.[227] In that process CCA concluded that the TDR and Adris Group abused its dominant position in the Croatian cigarettes market from August 15th, 2004 till December 31st, 2010 thus creating a network of exclusive buyers with the intention of excluding or restricting access to the market for its competitors. Companies from Rovinj abused their dominant position through the general terms and conditions and through the agreement for the sale and promotion of cigarettes that TDR would agree with its buyers - wholesalers and retailers. In these agreements, as noted by CCA, customers were imposed with additional obligations for purchase of TDR's products for all their needs or most of their requirements for cigarettes in a given period, and TDR encouraged such purchases financially or rewarded with prohibited conditional retroactive rebates - the so-called loyalty rebates.[228]

Croatian accession to European Union caused lot of business problems for TDR. With the accession to the EU the Republic of Croatia has adopted a completely new legislative framework in the area of excise duties on tobacco products and has introduced a ban on exposure to tobacco products at retail stores, which is extremely rare practice among European countries. All of that was accompanied by a massive increase in the black market of cut tobacco. It is estimated that three-quarters cut tobacco sold illegally. According to the Empty Pack Survey, which measures the consumption volume of illicit cigarettes and cigarettes that are illegally sold on the Croatian market (by collecting of boxes in the streets and waste bins), illegal cigarettes market decreased from 12% to 5%. However, specific

[225] Source: http://www.poslovna.hr/subjekti.aspx?show=371962&tab=posl&stab=bil (12.07.2016.).
[226] Available at: http://liderpress.hr/biznis-i-politika/hrvatska/tdr-neizdavanje-markica-za-cigarete-steti-i-nama/ [22.6.2016.].
[227] Source: http://liderpress.hr/arhiva/134396/ (12.07.2016.).
[228] Source: http://www.aztn.hr/uploads/documents/odluke/TN/UPI-030-022006-01082.pdf (12.07.2016.).

measures did not contribute to that decease. The decrease in illegal cigarettes market was caused by reduced consumption of cut tobacco due to the increase in price of cut tobacco from 9,33 EUR to 36 EUR for one kilogram.[229]

After the Republic of Croatia exited Central European Free Trade Agreement (CEFTA) TDR found itself in a situation that customs on tobacco products in Serbia were supposed to increase from 15% to 57%. That would drastically affect the price of these products and thus jeopardize an important market for TDR. Serbia annually imported from 1.620 to 1.625 tons of cigarettes from the Republic of Croatia at the customs rate of 15%. TDR's management was even thinking about moving production from the Croatia into one of the CEFTA countries to avoid paying so high customs rates, but after pressure from Brussels TDR continued to sell cigarettes in Serbia, at the customs rate of 15%. Countries that in the past two terms entered the European Union were given up to seven years to adjust the price of cigarettes to the EU excise system. However, Croatia, as well as in other industries, during negotiations with the EU adopted harmonization of excise duties four years before joining the EU, which has brought much higher prices inadequate to purchasing power of Croatian consumers.[230]

A drastic increase in excise duty which reflected on the increase of the retail prices of tobacco products, decrease in purchasing power of Croatian population combined with a reduction in demand for tobacco products in key markets, strengthening of legislation directed against tobacco and permanent pressure competitors drastically influenced decrease in all key performance indicators of TDR. Therefore, it can be concluded based on all information analyzed that changes in TDR‘s profitability were caused by external factors (strong international competition, changing legislative framework, ect.) and proposed hypothesis H1 can be confirmed.

[229] Source: http://liderpress.hr/tvrtke-i-trzista/poslovna-scena/tdr-i-philip-morris-duopolizirali-trziste/ (13.07.2016.).
[230] Source: http://hr.seebiz.eu/industrija/tdr-poskupljuje-cigarete-nakon-nove-godine-razmislja-o-selidbi-dijela-proizvodnje/ar-51285/ (13.07.2016.).

5.3. Analysis of TDR acquisition by BAT

The media in Croatia often reported about the potential acquisition of TDR but the management structures of TDR and Adris Group as well regularly denied such speculations. After continual media speculation about the acquisition of TDR at the end of 2014, there was no other comment from Adris Group than that Adris Group is not able to add long-term value to its tobacco business segment thus opening up the possibility of establishing a partnership between TDR and some of the world's leading companies in the tobacco industry. At the beginning of 2015 China National Tobacco was interested in acquiring TDR, and according to business media they started with due diligence of TDR, while companies like Korean Tobacco and Japan Tobacco International also showed their interest in TDR.[231]

President of the management board of TDR, also a member of the Adris Group management board, Mato Zadro and representatives of the British American Tobacco signed a purchase agreement in London on May 30th, 2015 by which BAT becomes owner of TDR and all companies that operate within Adris's tobacco business unit – Istragrafika, Hrvatski duhani, and retail chains iNovine and Opresa. BAT paid 505 million EUR for TDR. Under that agreement BAT obligated to keep production in Kanfanar for least five years after the acquisition and provide an additional 50 million EUR in the case of early closure of production capacities there. After the signing the purchasing agreement CEO of TDR pointed out that they are satisfied with the valuation ratio of TDR and the protection of their workers as well as the fact that one of the world leaders in the tobacco industry recognized the added value of the integrated business model of TDR, which includes purchase and processing of tobacco, cigarette production, packaging, distribution and retail.[232] BAT also acquired Tobacco industry Vrenje in Serbia during 2003 for 87 million EUR.[233]

In accordance with the conclusions of the Adris Group's general assembly, held on January 20th, 2015 the shareholders, to whom the supervisory and the management board members recommended acceptance of the purchasing agreement, adopted the final decision on the transaction by providing an acceptance for sale of TDR during the general assembly held on

[231] Source: http://liderpress.hr/tvrtke-i-trzista/poslovna-scena/adris-dugorocno-je-razlozno-razmisljati-o-mogucem-partnerstvu-u-tdr-u/ (14.07.2016).
[232] Source: http://liderpress.hr/tvrtke-i-trzista/poslovna-scena/british-american-tobacco-postao-vlasnik-tdr-a/ (14.07.2016.).
[233] Source: http://marketnetwork.rs/retail/analiza/2064-trziste-cigareta-u-srbiji (14.07.2016.).

July 14th, 2015. Sources from Adris Group state that they will use the money received from the sale of TDR for further strengthening of Adris Group.[234]

TDR's sales revenues were, in its peak in 2007 till its bottom in 2014, high for standards of Croatian economy but when compared to sales revenues of top players in tobacco industry, those revenues were very modest. TDR's profitability margins shrink strongly after the Croatian accession to European Union, and TDR did not follow trends in tobacco industry when it comes to acquiring other competitors. Besides, owners of TDR stated that they were not able to add long-term value to their tobacco business unit, and when considering purchase price they received for TDR it can be concluded that sell off of TDR was prudent strategic decision for its shareholders instead of further internal developing of tobacco business. Therefore, second hypothesis is confirmed.

It is very interesting to analyze whether price paid for TDR was adequate compensation for TDR's shareholders. In order to make conclusions on that matter it is necessary to valuate TDR based on its performance at the end of 2014. One of the most common methods used for valuation purposes is comparable transactions method. Comparable transactions were selected based on industry criterion (tobacco industry) and geographical region (all transactions occurred in Europe). According to Mergermarket data base there were 83 transactions in European tobacco industry from 01.01.2000 till 10.7.2016.[235] Financial data was available for 20 transactions, and transaction and financial data is presented in table 5.2. and 5.3.

[234] Source: http://liderpress.hr/tvrtke-i-trzista/poslovna-scena/potvrdena-prodaja-tdr-a-adris-isplacuje-dividendu-od-10-kuna-po-dionici/ (14.07.2016.).

[235] Source: http://www.mergermarket.com/Common/Mergermarket/Deals/DealsSearchResults.aspx?currencyCode=EUR (14.07.2016.).

Table 5.2. Transactions in European tobacco industry in period 01.01.2000 – 10.07.2016.

No.	Announcement date	Completion date	TARGET	ACQUIRER
1.	22/11/2012	07/03/2013	Gleeson Group	C&C Group Plc
2.	24/05/2012	15/08/2012	Gryson NV	Japan Tobacco Inc
3.	13/09/2011	27/09/2011	Bulgartabac Holding AD (79.83% Stake)	BT Invest GmbH
4.	05/10/2009	05/10/2009	Galaxy Tobacco SA (53.71% Stake)	InterAgro SA
5.	02/07/2009	14/09/2009	Swedish Match South Africa (Proprietary)	Philip Morris International Inc
6.	08/08/2008	03/11/2008	British American Tobacco Plc (1.1% Stake)	Reinet Investments S.C.A.
7.	08/08/2008	03/11/2008	British American Tobacco Plc (9.6% Stake)	Remgro Limited (shareholders)
8.	08/08/2008	03/11/2008	British American Tobacco Plc (17.5% Stake)	Reinet Investments S.C.A. (Shareholders)
9.	18/07/2007	18/01/2008	Altadis SA	Imperial Tobacco Group Plc
10.	14/12/2006	18/04/2007	Gallaher Group plc	Japan Tobacco Inc
11.	06/07/2006	01/09/2006	N.V. Deli Maatschappij	NPM Capital N.V.; NIBC Principal Investments
12.	13/06/2006	13/06/2006	Conviviality Plc	Bargain Booze Limited (MBO vehicle)
13.	04/03/2005	04/03/2005	British American Tobacco Plc (1% Stake)	Remgro Limited
14.	30/07/2004	30/12/2004	Etinera	Axiter SpA
15.	16/07/2003	23/12/2003	Ente Tabacchi Italiani (ETI)	British American Tobacco Plc
16.	06/05/2003	15/10/2003	Papastratos Cigarette Company SA	Philip Morris International Inc
17.	07/03/2002	15/05/2002	Reemtsma Cigarettenfabriken GmbH	Imperial Tobacco Group Plc
18.	29/08/2001	21/01/2002	Austria Tabak (59% Stake)	Gallaher Group plc
19.	22/06/2001	21/08/2001	Austria Tabak	Gallaher Group plc
20.	02/04/2001	02/04/2001	Tobaccor	Imperial Tobacco Group Plc

Source:http://www.mergermarket.com/Common/Mergermarket/Deals/DealsSearchResults.aspx?currencyCode=EUR (14.07.2016.).

Table 5.3. Transaction multiples in European tobacco industry in period 01.01.2000 – 10.07.2016.

No.	Deal Value EUR(m)	Revenue EUR(m)	Revenue multiple	EBITDA multiple	EBIT multiple
1.	58	246,9788	0,2348	5,6863	12,2702
2.	475	86,7	5,4787	-	16,3793
3.	25	159,1751	0,3242	4,8737	4,8737
4.	27	5,92	8,5884	-	-
5.	157	63,4099	2,4794	-	-
6.	515	13484,9913	4,3798	13,5382	15,104
7.	4631	13484,9913	4,4938	13,8905	15,4971
8.	8428	13484,9913	4,4875	13,8711	15,4755
9.	15093	12503,403	1,2071	12,0877	14,3773
10.	14549	11951,1131	1,187	13,4674	16,2778
11.	404	1155,6876	0,3693	-	9,7547
12.	88	647,2057	0,1424	5,4139	5,6304
13.	181	48416,9611	0,7571	9,316	13,3827
14.	590	194	3,0412	9,7682	-
15.	2325	777	2,9923	35,3346	77,2431
16.	523	403,7	1,5758	14,4907	16,2033
17.	5189	2350,1691	2,4702	12,6638	-
18.	1397	3725,9841	0,5789	7,4817	11,0885
19.	766	3725,9841	0,5565	7,1918	10,6589
20.	289	244,4444	1,5498	-	7,2324

Source:http://www.mergermarket.com/Common/Mergermarket/Deals/DealsSearchResults.aspx?currencyCode EUR (14.07.2016.).

In order to arrive to an estimate of TDR's equity value it is necessary to calculate median multiples from comparable transactions. Sometimes average multiples are calculated but it is better to use median multiples since average multiples include highest and lowest multiple values, and therefore median multiples provide better estimate of equity values. Median multiples based on 20 acquisitions in European tobacco industry are presented in table 5.4.

Table 5.4. Median multiples

Multiples - MEDIAN	Revenue multiple	EBITDA multiple	EBIT multiple
All transactions	1,56	12,09	13,88
Transactions 2001-2007	1,20	10,93	12,24

Source: Author.

When median multiples are calculated they are used to calculate value of TDR's equity. Revenue multiple is used to multiply with TDR's revenues in 2014, EBITDA (earnings before interest, tax, depreciation and amortization) multiple is used to multiply with TDR's EBITDA in 2014, and EBIT (earnings before interest, and tax) multiple is used to multiply with TDR's EBIT in 2014 to arrive at estimate value of TDR's equity. After calculating estimate of TDR's equity value based on three multiples (revenue, EBITDA and EBIT) average value is used to determine TDR's equity value. That calculation is presented in following table.

Table 5.5. Valuation of TDR based on comparable transaction method

Valuation of TDR (Euro)	2014	Multiples	Equity value	Average value
Revenues	136.189.400	1,56	212.455.464	249.940.040
EBITDA	26.628.667	12,09	321.940.580	
EBIT	15.520.467	13,88	215.424.077	

Source: Author.

By using comparable transactions method it can be concluded that TDR's equity value, based on 20 transactions in European tobacco industry, at the time when BAT acquired TDR was 249.940.040 EUR. When that estimated value is compared with 505.000.000 EUR paid for TDR it is obvious that TDR's shareholders can be very satisfied with the cash they received from the sale. Transaction price was twice higher than estimated value, and acquisition premium was 102%. The reason for such high premium can be explained through extraordinary negotiation skills of TDR's owners, and also with the fact that BAT was acquiring a leader in Croatian tobacco market with strong presence in key retail stores in Croatia. Another fact that contributed to such high acquisition premium is TDR's vertically integrated model which was all included in this transaction (Istragrafika, Hrvatski duhani, and retail chains iNovine and Opresa). Although, the price paid for TDR by BAT in 2015 can be described as a great success of TDR's shareholders it is necessary to analyze what would happen if TDR was acquired in 2008, soon after company reached its peak in performance (2007). Valuation of TDR by using comparable transaction method based on comparable multiples in period 2001 – 2007 and based on TDR's performance in 2007 is presented in 5.6.

Table 5.6. Valuation of TDR based on comparable transaction method based on key performance indicators in 2007

Valuation of TDR (Euro)	2007	Multiples	Equity value	Average value
Revenues	269.365.430	1,20	323.238.516	858.628.510
EBITDA	103.441.730	10,93	1.130.618.112	
EBIT	91.669.028	12,24	1.122.028.903	

Source: Author.

As it can be seen from previous table, estimate of TDR's equity value based on its key performance indicators in 2007 equals 858.628.510 EUR. If we take into consideration that TDR had the biggest share in Croatian market in 2007, and great negotiation skills of its majority shareholders (Adris Group) it can be concluded that acquisition of TDR during 2008 would be worth more than billion EUR (if same acquisition premium of 102% like in 2014 would apply, TDR's transaction value would be 1,7 billion EUR). Therefore, it can be concluded that shareholders of TDR would be better off if TDR was acquired at the begging of 2008 instead in 2015, so third hypothesis of this thesis can be confirmed.

5.4. Limitations and suggestions for future research

The limitations are related the methodology used in this thesis. Case study is a prominent approach in the social sciences, and especially in field of M&A, but it has been the subject of critiques. "Critics of the case study as a research method tend to be academics embracing a positivist mindset. For them, the quality of a piece of research should be evaluated according to the positivist criteria of construct validity, internal and external validity, and reliability."[236] Critics give arguments like impossibility of ensuring objectivity by the researcher. Also it is difficult to ensure that the processes of deduction are logical, controlled, and free from false

[236] Mariotto, F. L., Pinto Z. P., De Moraes, G. H. S. M. (2014.), What is the use of a single-case study in management research?, *RAE Revista de Administração de Empresas*, 54 (4): 359.

or subjective evidence.[237] From positivist perspective, the biggest restraint of this method is its failure in generalization of findings.[238] It is also important to point out that every research approach has its limitations which are subjected to bias. When using survey based approach bias of research participants is always present, and when using accounting approach manipulation with accounting categories in financial statements pose threat to sound research findings. Furthermore, event study methodology focuses on short term effects of M&A announcements on share price, and share price is affected by variety of factors besides announcement of M&A.

In order to diminish the stated limitations, the suggestions for future research are related to the research method. Since the case study of TDR utilized the secondary data, suggestion is to broaden the research with primary source of data, meaning surveys and interviews. It would be interesting to analyze the integration of TDR to BAT's business system, and to examine how it influenced financial results and market position of TDR and BAT. It would be also interesting to identify the changes regarding organizational structure, culture and strategic positioning of TDR especially in terms of decisions regarding relocation of the production processes.

[237] Lee, A. S. (1989.), A scientific methodology for MIS case studies, *MIS Quarterly*, 13(1): 33-50.
[238] Mariotto, F. L., Pinto Z. P., De Moraes, G. H. S. M. (2014.), What is the use of a single-case study in management research?, *RAE Revista de Administração de Empresas*, 54 (4): 360.

6. CONCLUSIONS AND RECOMMENDATIONS

Mergers and acquisitions, as the most popular way of implementing growth strategy, help companies to strengthen their market position much faster than when they rely on organic growth. Mergers and acquisitions play significant role in global tobacco industry. In period from 2000 until the end of June 2016, 115 transactions occurred in global tobacco industry, and 78% of them (total of 91 transactions) were characterized as cross-border. All leading companies from tobacco industry participated in these transactions which sheds light on the importance of mergers and acquisitions in tobacco industry. In 2015 four transactions have been completed, and special focus in this thesis was directed on one of those transactions – acquisition of Tvornica duhana Rovinj by British American Tobacco for 505 million EUR.

In order to understand all important events regarding TDR-BAT transaction M&A trends in global tobacco industry were analyzed as well as leading companies in the industry. The leader in global tobacco industry is China National Tobacco while other companies in industry top 5 ranking include BAT, PMI, Altria Group and JTI. All leading companies have high and steady profit margins, and despite increasing legislative pressures on tobacco industry, they manage to increase their revenues. In contrary, after 2007 when TDR had peak in its performance, its revenues together with its profit margins were shrinking. Main reasons for decrease of TDR's performance can be related to increase of the retail prices of tobacco products along with decrease of purchasing power of Croatian population combined with a reduction in demand for tobacco products in key markets. Strengthening of legislation directed against tobacco and permanent pressure of competitors due to accession of Republic of Croatia to European Union drastically influenced decrease in all key performance indicators of TDR. Therefore, it was concluded that changes in TDR‘s profitability were caused by external factors (strong international competition, changing legislative framework, ect.) and, therefore first hypothesis of this thesis was confirmed.

This research also focused on whether acquisition of TDR was good decision for its shareholders or the company could prosper with further organic growth. TDR's sales revenues were, in its peak in 2007 till its bottom in 2014, high for standards of Croatian economy but when compared to sales revenues of top players in tobacco industry, those revenues were very modest. Analysis of recent trends in global tobacco industry indicated that all major industry players are engaged in M&A area, especially BAT, and TDR did not follow trends in tobacco industry when it comes to acquiring other competitors. Besides, owners of TDR stated that they were not able to add long-term value to their tobacco business unit, and when considering high purchase price they received for TDR it was concluded that sell off of TDR was prudent strategic decision for its shareholders instead of further internal developing of tobacco business. Therefore, second hypothesis of the thesis was confirmed.

Since TDR was acquired in 2015, it was interesting to examine what would happen if TDR was acquired soon after its peak in business performance. By using comparable transactions method value of TDR's equity was estimated using comparable multiples and performance indicators from 2007, and 2014 as well. Estimate of TDR's equity value based on its key performance indicators in 2007 was 858.628.510 EUR. The fact that TDR had the biggest share in Croatian market in 2007 was taken into consideration, great negotiation skills of its majority shareholders (Adris Group) as well, and it was concluded that acquisition of TDR during 2008 would be worth more than billion EUR. Therefore, it was concluded that shareholders of TDR would be better off if TDR was acquired at the begging of 2008 instead in 2015, so third hypothesis of this thesis was be confirmed.

When all the facts analyzed in this thesis are observed it is obvious that TDR's strategy did not follow trends in global tobacco industry. Instead of protectionism that they enjoyed for several years they should have engaged in M&A processes in neighboring countries and try to strengthen their position in relation to competition. If they have engaged in cross-border M&A they could prevent the continuous decrease of their revenues. That was the only way to conduct business if they wanted to compete in global tobacco industry. If that was not their goal, TDR was sold off far too late, and shareholders lost a lot money due to unclear strategy of TDR's management and major shareholders.

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