Study on Financial Risk and Countermeasures in Enterprise Mergers and Acquisitions--Take LVMH's Acquisition of Tiffany as an Example

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Abstract. M&A is an important approach for enterprises to achieve industrial upgrading and scale effect, reduce operating costs, and promote the diversified development of enterprises. The financial risks that often appear in the process of M&A are the key to the success of M&A and the reorganization of enterprises. Existing equity and economic problems make enterprises easily fall into financial disputes and cause huge losses. Investment and mergers are important ways for enterprises to expand scale, enter new markets, and acquire new technologies or mature brands. Through investment and merger, market share can be increased, competitiveness can be enhanced, and the financial statements of enterprises can be enhanced, but risks in merger and acquisition are also accompanied. Through the case study of LVMH Group's merger and acquisition of Tiffany, this paper will analyze the financial risks and countermeasures in the merger and acquisition and extract feasible and effective measures from LVMH Group's treatment methods to help both parties control the risks in the merger process and achieve the purpose of merger and acquisition.

1 Introduction

M&A is an important approach for enterprises to achieve industrial upgrading and scale effect, reduce operating costs, and promote the diversified development of enterprises [1]. The financial risks that often appear in the process of M&A are the key to the success of M&A and the reorganization of enterprises. Existing equity and economic problems make enterprises easily fall into financial disputes and cause huge losses.

Based on previous studies, this study will take the case of M&A between LVMH and Tiffany as an example, conducting quantitative and qualitative analysis of several types of financial risks that may occur in the M&A process according to the performance of the financial statements of both parties and understanding the specific causes and potential problems of financial risks, and find effective prevention and control strategies through specific cases.

2 Case description

2.1. M&A background

LVMH Group's 2019 financial report shows that operating income increased by 15% compared with 2018, and net profit increased by 9%. The revenue structure shows that the revenue of the leather goods sector accounts for the vast majority of the operating income of the LVMH group, which is about 41%, but the revenue of the watch jewelry sector accounts for only 8%.

According to the official website, there are only six brands in the LVMH watch and jewelry sector: Tag Heuer, Hublot, Zenith, Bulgari, Chammel, and Fred.

As a classic brand in the field of jewelry and watches, Tiffany has an irreplaceable influence on product design and brand image. However, since 2016, Tiffany's performance has continued to decline, especially in the second quarter of 2019. Global same-store sales fell 3% from last year, about twice as much as expected, and sales fell into a regressive state in Japan and Europe except for a slight increase in China. Under such an environment, it is a good time for LVMH Group to acquire Tiffany [2].

2.2 M&A motivation

Due to the special nature of the luxury industry, brand effect is an important intangible asset, so the acquisition of high-value brands can effectively enhance brand influence, and merger and acquisition is an important way to obtain it [2]. Although LVMH Group has become the world's largest luxury goods group, there is still a big gap in the field of jewelry watches compared with other competitors. LVMH jewelry brands are mostly acquired, but its competitors, Van Cleef & Arpels, Cartier, and other brands under Richemont Group, have higher brand awareness and market experience, and the revenue growth and scale in the field of jewelry watches far exceeds the value of LVMH Group's jewelry watch business. As a result, Tiffany, which is well-known and
influential in the field of jewelry watches, has received the attention of LVMH Group.

2.3 M&A progress

LVMH announced that it would acquire Tiffany for $135 per share for a total of about $16.2 billion in November 2019. However, the United States announced in July 2020 that it planned to impose 25% tariffs on French imports of cosmetics and other goods, so LVMH Group announced in September that it would postpone the acquisition of Tiffany. Subsequently, the two sides began to sue each other for the "feud" plot: Tiffany first sued LVMH for failing to complete the acquisition on time and tried to renegotiate the acquisition price. Not long after that, LVMH also chose to sue, accusing Tiffany of mismanagement during the new coronavirus outbreak to shrink its revenue, and applied to cancel the transaction at the original price. On October 29, 2020, the acquisition made progress. LVMH announced that it had reached an agreement with Tiffany on the modification of the merger agreement, and the acquisition price was adjusted to $131.5 per share under the condition that the remaining terms remained unchanged, completing the acquisition at a total price of $15.8 billion [3]. In the end, the acquisition was officially completed on January 7, 2021.

3 Analysis

3.1 Theoretical basis

3.1.1 Information asymmetry theory

The theory of information asymmetry refers to the difference in understanding of relevant information among different groups in the market economy. Those with sufficient information are often at an advantage, while those with poor information are often at a disadvantage. At the same time, the theory points out that the seller knows more about the commodity information than the buyer in the market. The party with more information can benefit by providing reliable information to the party with less information. One of the buyers and sellers with less information will try to obtain information from the other [4].

3.1.2 Synergistic effect theory

Synergy takes into account the resource integration and synergy between the two parties after the completion of the merger or acquisition to maximize the value of resources, while the focus of this study is the financial embodiment of enterprises to achieve reasonable tax avoidance or reduce the cost of capital through merger and acquisition.

3.2 Financial risk analysis

The financial risk of M&A is divided into two stages: strategic investment and performance process acquisition [5]. Next, from the perspective of the financial risks that are prone to occur in the two stages -- valuation risk and integration risk, this paper analyzes the financial risks in M&A and the coping policies of LVMH Group.

3.2.1 Valuation risk analysis

The essence of M&A is the transfer of corporate control, and the process is reflected in that the M&A party judges the market valuation of the transferring enterprise through advanced market research and decision analysis and negotiates with the transferring to reach an agreement on the M&A price. From the perspective of the acquirer, if the valuation is too low, it is easy to reduce the cooperation willingness of the transferring and reduce the success rate of the merger. Suppose the valuation is too high and exceeds the actual value of the enterprise. In that case, the enterprise will increase the capital cost and find it difficult to reap the expected benefits, and even lead to serious consequences such as the rupture of the enterprise's capital chain, which will affect the subsequent production and respect activities of the enterprise [6].

In the merger and acquisition case between LVMH and Tiffany, the cooperation was terminated due to differences in valuation and pricing, which was related to the information asymmetry between the two parties to a certain extent. The decrease in the acquisition price from $135 per share to $131.50 per share is related to many factors, including Tiffany's operating performance during the acquisition negotiations, and LVMH Group's knowledge of Tiffany's revenue performance becomes the key to pricing. According to Tiffany's financial report data before the acquisition, Tiffany suffered a huge loss in revenue and profit in the first quarter of 2020, and although there was a rebound in the second and third quarters, it was far less than the revenue performance in the fourth quarter of 2019, as shown in Table 1.

<table>
<thead>
<tr>
<th>Year</th>
<th>Q1</th>
<th>Q2</th>
<th>Q3</th>
<th>Q4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit (units: billion)</td>
<td>269</td>
<td>-92.8</td>
<td>63.7</td>
<td>179.5</td>
</tr>
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The choice of valuation method often affects the formation of pricing risk. Revenue-based free cash flow method is applied to the acquisition price of LVMH Group, and the change curve in Figure 1 is obtained after sample fitting.
In the first quarter of 2020, Tiffany's cash flow showed a dramatic decline, which is closely related to Tiffany's sluggish performance; Although there was a small recovery in the last two quarters, it was difficult to return to the level before the epidemic. Free cash flow reflects the future debt repayment and profitability of the enterprise. Tiffany's earnings performance in the first half of 20 years made it difficult for the two parties to continue the cooperation, but the subsequent return of earnings and revaluation made the cooperation between the two parties successfully reached.

3.2.2 Integrated risk analysis

Financial integration risk refers to the hidden danger of disputes arising from the inconsistency of corporate culture, organizational management form, business process, and functional division of department personnel during business integration, resulting in the failure of the enterprise to effectively integrate business and resources within the expected time, which has an impact on the profitability level and the development of production and business activities in subsequent stages [6]. If integration risks are effectively prevented, effective synergies can be achieved in future development. In response to this risk, LVMH chose to send LV chairman and CEO Michael Burke, who will also serve as chairman of Tiffany, LV in the United States and the brand's global commercial activities. Anthony Ledru will serve as CEO of Tiffany. The two are responsible for operating Tiffany and said it plans to overhaul its design team.

In the comparison of the performance in 2021 and 2020, the jewelry and watch business is the brightest business segment of the LVMH Group in 2021, which has to be attributed to the great merger and acquisition of Century of Tiffany. This jewelry brand with pure American genes achieved the growth of three indicators of revenue, profit, and cash flow in the first year after joining the LVMH family and led jewelry watches to become the third largest business segment of LVMH, with the revenue proportion increasing from 7.5% in 2020 to 14.0%. The share of profits increased from 3.6% in 2020 to 9.8% [7].

4 Suggestion

In the scheme of risk control in the pricing of M&A projects, the enterprise can adopt several control measurements, including making clear merger and acquisition strategy and transfer research, optimizing evaluation methods, evaluating their own resources' joint ability, and entrusting professional institutions [6].

4.1 Make M&A strategy clear

The objectives of M&A and reorganization of enterprises have the characteristics of diversification, and the common objectives include expanding business areas and forming scale synergies. Due to the differences in M&A prices and work priorities under different targets, enterprises must determine M&A targets based on their actual conditions and formulate clear M&A strategies to guide the follow-up work. For example, in this case, LVMH is trying to expand the field of jewelry watches and form synergies through mergers and acquisitions, so it needs to focus on the value the transfer can create in terms of performance, brand effect, and resource allocation.

4.2 Conduct thorough due diligence

According to the case of the LVMH merger and acquisition of Tiffany, there is a general information asymmetry between the acquirer and the transferring, which often leads to the regret or willingness of the acquirer to give up the acquisition during the merger and acquisition process. Therefore, to ensure the smooth progress of the merger and the rights and interests of both parties and avoid the premium of the merger price, it is necessary to grasp the transfer's real production and operation conditions fully. In this regard, in the investigation process, enterprises should collect as much information as possible from all aspects of the enterprise, starting from the internal and external environment of the enterprise, verify the status and value of assets, especially intangible assets, analyze the geographical advantages and brand effect of the acquired enterprise, verify the actual value of the acquired enterprise, and eliminate the impact of information asymmetry. It is also
necessary to pay special attention to the situation of corporate debt, do a good job in debt analysis, and prevent the deliberate concealment by the target company from causing great interference to the judgment of corporate value and future profitability, fully understand the core value of the target company, and know yourself and the other [8].

4.3 Optimizing valuation method

Enterprises should choose valuation methods according to M&A conditions and strategic objectives. For example, if the main goal of M&A is to improve profit, the cash flow method can be preferred to determine the present value of the enterprise. Suppose similar M&A activities of brands are active. In that case, a group of enterprises with high similarity can be selected as samples to set price-earnings ratio, enterprise value income, and other indicators, and the comparative valuation method can be used to accurately evaluate the market value of M&A objects under sample reference.

4.4 Entrusting professional agency

Enterprises need to collect more information about the target enterprise, choose the most appropriate valuation method in the face of multiple valuation methods, and hire professional intermediaries to reduce valuation risks [9]. Compared with LVMH, a large-scale group with rich experience in mergers and acquisitions, professional institutions are more suitable for enterprises with limited scale or lack of experience in mergers and acquisitions and can obtain more objective and reasonable evaluation prices by entrusting a third party to carry out market research and enterprise value estimation on their behalf.

4.5 Financial integration risk control

According to the preliminary research results, after the completion of the merger and acquisition, the enterprise needs to build a new financial management structure, and on the premise of ensuring normal work, reduce the management structure levels, merge departments with similar functions, and explain relevant matters to the original employees in advance. At the same time, in terms of the integration of assets and liabilities, the disposal plan of various assets should be formulated in advance according to the actual situation, and the financing assets should be quickly put into the newly launched production and operation activities [10].

5 Conclusion

M&A is an important approach for enterprises to achieve industrial upgrading and scale effect, reduce operating costs, and promote the diversified development of enterprises. In the merger and acquisition process, enterprises will get higher benefits but also face many potential financial risks in the negotiation process and integration period. In the case of analysis of M&A between LVMH and Tiffany, it can be seen from the obstacles encountered in the merger process, and the financial integration after the completion of the merger that financial risks run through the whole process of the merger and reorganization of enterprises, and the effect of risk control has a profound impact on the success rate of the merger and the production and operation of enterprises. The same goes for leading enterprises in the luxury industry. Enterprises in the same field and other fields should also improve various financial risks in the M&A process, actively implement pricing and financial integration risks, and help enterprises achieve the expected M&A objectives and maximize the synergistic benefits after the M&A.

References

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