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UKRAINIAN M&A MARKET: PERSPECTIVES AND RISKS

УКРАЇНСЬКИЙ РИНОК УГОД ЗЛИТТЯ І ПОГЛИНАННЯ: ПЕРСПЕКТИВИ І РИЗИКИ

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Introduction. The Ukrainian M&A market is very small in volume but has very high prospects for development. For the sake of transparency in this market there should be, for the first time, a method of honest valuation and audit, as well as an ethics of the operation of the merger and acquisition market. For fair valuation, there are various valuation strategies and methods that need to be implemented into the market, namely (DCF, Multipliers, Fundamental & Technical Analysis).

Purpose. The purpose of the article is to explore the concepts, strategies and methods of valuation in mergers and acquisitions.

Results M&A in Ukraine, as a process, is a new phenomenon, which suggests the emergence of a structure for this process, and new world standards for this very event. Let's look at the primary characteristics of the term M&A, and what it means: "Mergers and acquisitions (M&A) is a general term that refers to the consolidation of companies or assets through various types of financial transactions." The methods of M&A vary depending on the purpose of the company which absorbs, for the best understanding, of these processes there are a different method, horizontal, vertical etc. The most common method is to look at comparable company or value it in one of these methods: Comparative Ratios, Price-Earnings Ratio (P/E Ratio), Discounted Cash Flow (DCF)." Process of M&A deals can hedge a lot of risks, and can save business from different problems, such as hostile acquisitions, bankruptcy, high taxes and antitrust law.

Conclusion. The Ukrainian M&A market is very small in volume but has very high prospects for development and situation with this market in the case of Ukraine may serve as green or red flags for foreign investors, and the more transparency the market will provide, the valuation of companies and the publicity of the process, the more attractive the Ukrainian economy will look to private investors.

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Вступ. Український ринок угод по злиття та поглинанню є дуже малим за об'ємами але при цьому має дуже великі перспективи розвитку. Майже всі угоди які відбуваються на ринку не мають достатньої прозорості, щоб забезпечувати прозорість цього ринку, вперш за все повинен існувати метод чесною оцінки компанії і аудиту, а також етика функціонування ринку злиття і поглинань.

Мета статті – дослідити поняття, стратегії та методи оцінки при злитті та поглинанні.

Результати. М&А в Україні як процес – це нове явище, яке передбачає появу структури цього процесу та нових світових стандартів для цієї самої події. Давайте розглянемо основні характеристики терміну М&А, та що це означає: "Злиття та поглинання (М&А) – це загальний термін, який відноситься до консолідації компанії або активів за допомогою різних видів фінансових операцій." Методи М&А різняться залежно від цілі компанії, яка для кращого розуміння цих процесів використовує різні методи, горизонтальні, вертикальні тощо. Найпоширеніший метод – це переглянути порівняльну компанію або оцінити її одним із таких методів: порівняльні коефіцієнти, коефіцієнт цінних доходів (коефіцієнт Р/Е), дисконтований грошовий потік (DCF). Процес угод з М&А може уникнути багатьох ризиків і може врятувати бізнес від різних проблем, таких як ворожі придбання, банкрутство, високі податки та антимонопольне законодавство.

Висновки. Підсумовуючи, можна зробити висновок, що правильна оцінка вартості компанії може не тільки впливати на майбутню угоду, але й на усі сфери діяльності взагалі. Окремі угоди злиття та поглинання у випадку України можуть служити зеленими або червоними прапорами для іноземних інвесторів. І чим більшу прозорість буде забезпечувати ринку оцінка компаній та публічність самого процесу, тим більш привабливою буде виглядати економіка України для приватних інвесторів. Зараз ми можемо спостерігати тільки зародження ринку М&А в Україні, але перспективи, які за собою може нести ефективне імплементація в українські бізнес реалії, можуть допомогти розвивати максимально ефективну Українську економіку.

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Украинский рынок М&А очень небольшой по объему, но имеет очень высокие перспективы для развития. Цель статьи - исследовать понятие, стратегии и методы оценки при слиянии и поглощении. М&А в Украине как процесс – это новое явление, которое предусматривает появление структуры этого процесса и новых мировых стандартов для этой самой события. Украинский рынок слияний и поглощений очень небольшой по объему, но имеет очень высокие перспективы развития. И ситуация с этим рынком в случае для Украины может служить зелеными или красными флагами для иностранных инвесторов. И чем большей прозрачностью рынок обеспечит оценку компаний и публичность этого процесса, тем привлекательней будет украинская экономика для частных инвесторов.

Keywords: M&A deal, investment banking, deals strategy, valuation, deal closing, P/E ratio, DCF, mergers, acquisitions, consulting & advisory

Ключові слова: M&A угода, інвестиційний банкінг, стратегія угод, оцінка, інвестиційна оцінка, закриття угод, співвідношення P/E, дисконтованні грошові потоки, злиття, поглинання, консалтинг та консультації, DCF

Ключевые слова: M&A сделка, инвестиционный банкинг, стратегия сделок, оценка, инвестиционная оценка, закрытие сделок, соотношение P/E, дисконтованные денежные потоки, слияния, поглощения, консалтинг и консультации, DCF

INTRODUCTION

The Ukrainian M&A market is very small in volume but has very high prospects for development. Almost all transactions occurring on the market don't have sufficient transparency and are not satisfactory to international standards for the conduct of M&A transactions. For the sake of transparency in this market there should be, for the first time, a method of honest valuation and audit, as well as an ethics of the operation of the merger and acquisition market. For fair valuation, there are various valuation strategies and methods that need to be implemented into the market, namely (DCF, Multipliers, Fundamental & Technical Analysis)

The **PURPOSE** of the paper is to explore the concepts, strategies and methods of valuation in mergers and acquisitions. The article deals with the basic modern concepts, strategies and methods of valuation of companies in M&A agreements, gives examples of successful agreements in Ukraine and abroad, as well as the main effects obtained from the correct implementation of these methods.

RESULTS

M&A in Ukraine, as a process, is a fairly new phenomenon, which suggests the emergence of a structure for this process, and new world standards for this very event. Nevertheless, today everything is not as rosy as we would like, why? First of all, this is only due to the fact that the format of the economy, which is now observed in Ukraine, is not yet ready for the implementation of M&A transactions, precisely in the format in which we expect it. Let's look at the primary characteristics of the term M&A, and what it means:

“Mergers and acquisitions (M&A) is a general term that refers to the consolidation of companies or assets through various types of financial transactions. M&A can include a number of different transactions, such as mergers, acquisitions, consolidations, tender offers, purchase of assets and management acquisitions. In all cases, two companies are involved. The term M&A also refers to the department at financial institutions that deals with mergers and acquisitions. The following will review some of

the different kinds of financial transactions that occur when companies engage in mergers and acquisitions activity.” [1]

From this we can understand that any transaction for the purchase of an enterprise or its part, to some extent, an M&A transaction. The most important aspect of activity in this case, everything converges, and in Ukraine, to a certain extent, such M&A rules apply, but the definition of this process consists not only in the term and name.

Ukrainian market of M&A has short enough history, it takes place first of all because Ukraine not so long ago found independence, and got the first signs of market economy, that until now is transformed, depending on political guidance of country. Nevertheless, from good heritage of the USSR, favorable terms of conduct of agriculture, comfortable location on transit territory between Asia and Europe and eventual rich on minerals earth, Ukraine however remains attractive for investors. History has, as well as flights so of falling, last flight it is possible to consider pre-crisis 2005-2008 years, when the Ukrainian market was most attractive from stability economic and political situation. Situation with M&A market for last several years was very bad, it was due not stable political situation, inflation growth and currency risks. Nevertheless, in such situation investors make some investments in Ukraine, but market share was pity. According to KPMG 2018 M&A annual report that illustrated on Fig. 1, we can see that situation become much more better since 2013.

But, if we look not only the value of M&A deals, but on the quantity of them in the Fig. 2, we can see that from the 2014 amount of M&A deals grow, but still situation not so good as in 2013, and we need few years to reach 2013 level.

But in the methods of M&A, in turn, they also make the most different, which vary depending on the purpose of the company which absorbs, for the best understanding, of these processes in Ukraine, for each type, a brief description of the method and an example of such a transaction will be given. Based on this, we can observe the following methods [2].

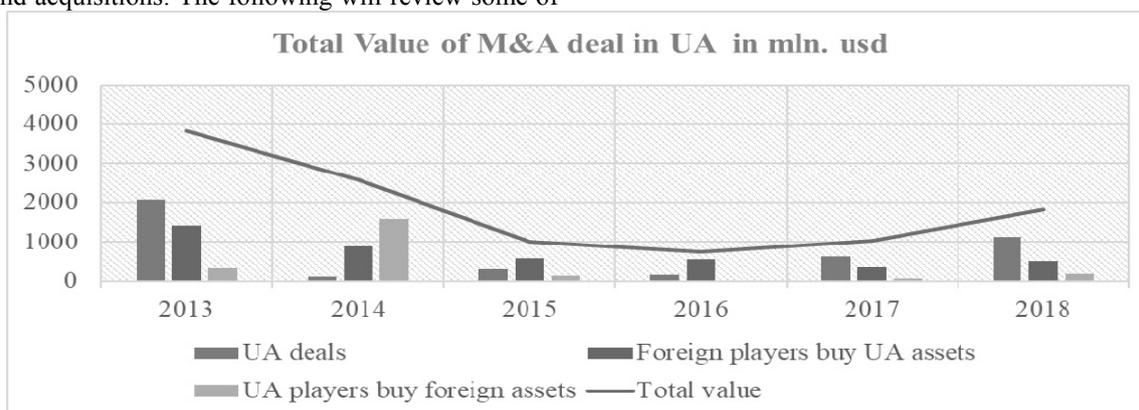


Fig. 1. Dynamic of total value of M&A deals in Ukraine in mln. USD 2013-2018 [based on information from [3]]

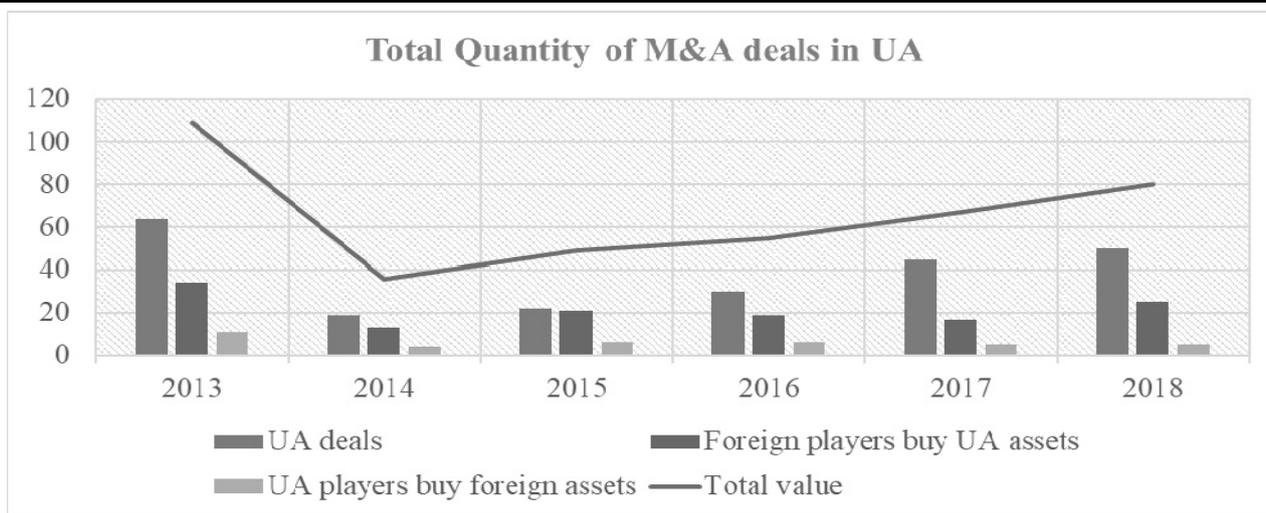


Fig. 2. Dynamic of total quantity of M&A deals in Ukraine 2013-2018 [based on information from [3]]

Horizontal merger. Two companies that are in direct competition and share the same product lines and markets. One of the example of such M&A deal in Ukraine can be deal between “Rozetka” when they bought company in internet retail from EVO Group, named Naspers. Rozetka made it to make their wealthy stronger in Ukrainian internet retail, it costs more than 15 million dollars.

Vertical merger. A customer and company or a supplier and company. Think of a cone supplier merging with an ice cream maker.

Congeneric mergers. Two businesses that serve the same consumer base in different ways, such as a TV manufacturer and a cable company.

Market-extension merger. Two companies that sell the same products in different markets. The best example of such deal in Ukrainian market can be the deal between Mriya Farming PLC и Saudi Agricultural and Livestock Investment Co. (SALIC). This is one of the biggest M&A deal in Ukraine and it shows that Ukrainian market is really interesting for foreign investors.

Product-extension merger. Two companies selling different but related products in the same market.

Conglomeration. Two companies that have no common business areas. There are two types of mergers that are distinguished by how the merger is financed. Each has certain implications for the companies involved and for investors:

Purchase Mergers. As the name suggests, this kind of merger occurs when one company purchases another company. The purchase is made with cash or through the

issue of some kind of debt instrument; the sale is taxable. Acquiring companies often prefer this type of merger because it can provide them with a tax benefit. Acquired assets can be written-up to the actual purchase price, and the difference between the book value and the purchase price of the assets can depreciate annually, reducing taxes payable by the acquiring company.

Consolidation Mergers. With this merger, a brand new company is formed, and both companies are bought and combined under the new entity. The tax terms are the same as those of a purchase merger.

Now that the strategies of M&A have become clear, and their goals, too, it remains to understand how to properly evaluate companies, or more precisely, how companies in Ukraine evaluate, where there is a very important problem, this is a poorly functioning securities market that raises many questions, in particular the correctness of a transaction, namely the value of the M&A deals. Why is this so important? Because, an assessment of a public company that is freely traded on the stock market can be carried out by anyone with investment evaluation skills.

According to KPMG M&A report 2018 level of transparency in Ukrainian M&A market grew up in 2018, but not so as we can expect [3]. The Fig. 3 shows us can the level of transparent deals is better on deals with foreign players that buy UA assets, and that is good it shows that they are fair players and try to provide their standards into Ukraine, but situation with Ukrainian players that buy foreign assets is tragic and shows that Ukrainian players are still generally in shadow.

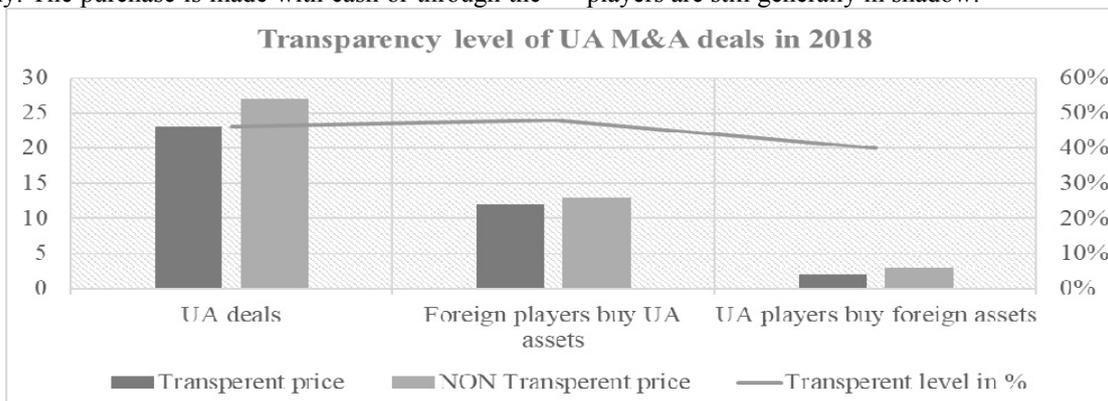


Fig. 3 Transparency level of M&A deals in Ukraine in mln. USD [based on information from [3]]

It is quite another thing, private companies or joint-stock companies that are not listed on the stock market. And because of this reason, there are various manipulations with the valuation of the company. A striking example of such a non-transparent assessment of an enterprise can be called the largest transaction in the history of Ukraine, the privatization of “Krivorizhstal”, when at the first stage of privatization, which can also be called an M&A deals, the company was sold for only 4.26 billion UAH to monopolists in the market, which in turn are connected with the leadership of the country [4]. But later the transaction was canceled due to non-transparent valuation methods and non-transparent auction conditions. After the repeated round of the auction, the company was already sold for UAH 24.2 billion, which exceeds the previous amount almost 5.7 times. In turn, this transaction describes a very important aspect of M&A deals in Ukraine; these are transactions for the purpose of privatizing state property, when, by a variety of methods, companies that are put up for sale are not privatized, without following all the rules for evaluating the transaction, thereby undervaluing the value of certain assets. And this doesn't end the problems of evaluating enterprises in Ukraine, but before continuing to consider the risks, it is worth moving to the classic methods of evaluating companies that now exist.

There are, however, many legitimate ways to value companies. The most common method is to look at comparable companies in an industry, but deal makers employ a variety of other methods and tools when assessing a target company. Here are just a few of them:

“Comparative Ratios. The following are two examples of the many comparative metrics on which acquiring companies may base their offers:

Price-Earnings Ratio (P/E Ratio). With the use of this ratio, an acquiring company makes an offer that is a multiple of the earnings of the target company. Looking at the P/E for all the stocks within the same industry group will give the acquiring company good guidance for what the target's P/E multiple should be.

Enterprise-Value-to-Sales Ratio (EV/Sales). With this ratio the acquiring company makes an offer as a multiple of the revenues, again, while being aware of the price-to-sales ratio of other companies in the industry.

Replacement Cost. In a few cases, acquisitions are based on the cost of replacing the target company. For simplicity's sake, suppose the value of a company is simply the sum of all its equipment and staffing costs. The acquiring company can literally order the target to sell at that price, or it will create a competitor for the same cost. Naturally, it takes a long time to assemble good management, acquire property and purchase the right equipment. This method of establishing a price certainly wouldn't make much sense in a service industry where the key assets – people and ideas – are hard to value and develop.

Discounted Cash Flow (DCF): A key valuation tool in M&A, discounted cash flow analysis determines a company's current value according to its estimated future cash flows. Forecasted free cash flows (net income + depreciation/amortization – capital expenditures – change in working capital) are discounted to a present value using the company's weighted average costs of capital (WACC).

Admittedly, DCF is tricky to get right, but few tools can rival this valuation method [5].

In the evaluation of an M&A deals, which should be transparent, three parties should take part, who in turn are obliged to ensure the transparency of the evaluation process, to ensure a “fair price”, and take into account all the prospects and risks of the company being absorbed, for this there are the following in Ukraine and the world instruments:

Investment Banks. Investment banks perform a variety of specialized roles. They carry out transactions involving huge amounts of money, in areas such as underwriting. They act as a financial advisor (and/or broker) for institutional clients, sometimes playing the role of an intermediary. They also facilitate corporate reorganizations, including mergers and acquisitions. The finance division of investment banks manages the merger and acquisition work, right from the negotiation stage until the deal's closure. The work related to the legal and accounting issues is out sourced to affiliate companies or inpaneled experts.

The role of an investment bank in the procedure typically involves vital market intelligence, in addition to preparing a list of prospective targets. Once the client is sure of the targeted deal, an assessment of the current valuation is done to know the price expectations. All of the documentation, management meetings, negotiation terms and closing documents are handled by the representatives of the investment bank. In cases where the investment bank is handling these side, an auction process is conducted with several rounds of bids to determine the buyer. Some of the major investment banks are Goldman Sachs (NYSE: GS), Morgan Stanley (NYSE: MS), JPMorgan Chase (NYSE: JPM), Bank of America Merrill Lynch (NYSE: BAC), Barclays Capital, City group (NYSE: C), and Credit Suisse Group (NYSE: CS).

Law Firms. Corporate law firms are popular among companies looking to expand externally through a merger or acquisition, especially companies with international borders. Such deals are more complex as they involved different laws governed by different jurisdictions, thus requiring very specialized legal handling. The international law firm sale best suited for this job with their expert is on multi-jurisdiction matters. Some of the leading law firms engaging in mergers and acquisitions are Wachtell, Lipton, Rosen&Katz.

Audit & Accounting Firms. Audit and accounting firms also handle a merger and acquisition deals with obvious specialization in auditing, accounting, and taxation. These companies are experts in evaluating assets, conducting audits and advising on taxation aspects. In cases where cross-border merger or acquisition is involved, the understanding of the taxation part becomes critical, and these companies fit well in such situations. Some of the well-known firms from this category with specialized services in mergers and acquisitions are KPMG, Deloitte, Price water house Coopers (PwC) and Ernst & Young (EY); these companies together are tagged as the Big Four.

Consulting & Advisory Firms. The leading management consulting and advisory firms guide clients through all stages of a merger or acquisition process – cross-industry or cross-border deals. These firms have a team

of experts who work towards the success of the deal right from the initial phase to the successful closure of the deal. The bigger companies in this business have a global footprint which helps in identifying targets base do suitability in all aspects. The firms work on the acquisition strategy followed by screen in to due diligence and advising on price valuations, making sure that the clients are not over-paying. Some of the well-known names in the business are AT Kearney, Bain and Company, The Boston Consulting Group (BCG), McKinsey and L.E.K. Consulting.

All these companies should be interested in the most honest and transparent assessment, because they, in turn, also carry risks, for example, in the USA, there is the most important risk, this is reputational risk, due to the slightest error in the assessment, the company loses its reputation and, accordingly, customers, but why is this impossible in Ukraine? This is impossible in Ukraine, due to the fact that the financial sector is not a locomotive of economic development here, and it is not so much a competitive market in Ukraine as in other countries, and there are several players who evaluate and support MA transactions, this is Finpoint, Concorde Capital, Dragon Capital, and Big 4 advisory. They are mainly involved in the support of such transactions, which ensures transparency of most of the market. But there still remains a large proportion, the shadow that carries out the assessment, for smaller players who, having no reputation and a large number of clients, unlike the above, are able to manipulate the assessment for one or another purpose. In turn, the transaction also has a clear regulation, which should ensure the complete purity of the transaction, up to the point that a company must come up with intentions to make it public, so that other market participants can prepare for changing market conditions. The transaction, in turn, has such 3 stages:

1. The Opening Offer. When the CEO and top managers of a company decide that they want to do a merger or acquisition, they start with a tender offer. The process typically begins with the acquiring company carefully and discreetly buying up shares in the target company or building a position. Once the acquiring company starts to purchase shares in the open market, it is restricted to buying 5 % of the total outstanding shares before it must file with the SEC. In the filing, the company must formally declare how many shares it owns and whether it intends to buy the company or keep the shares purely as an investment.

Working with financial advisors and investment bankers, the acquiring company will arrive at an overall price that it's willing to pay for its target in cash, shares or both. The tender offer is then frequently advertised in the business press, stating the offer price and the deadline by which the shareholders in the target company must accept or reject it.

A letter of intent, or LOI, is used to set forth the terms of a proposed merger or acquisition. It provides a general overview of the proposed deal. The LOI may include the purchase price, whether it is a stock or cash deal and other elements of the proposed deal. After the LOI is submitted, the buyer performs significant due diligence on the seller's business.

An LOI does not have to be legally binding upon the parties unless the terms of the LOI specifically states it is,

or it may include both binding and non-binding provisions. There may be provisions stating the buyer agrees to keep all confidential information it sees during due diligence secret.

2. The Target's Response. Once the tender offer has been made, the target company can do one of several things:

Accept the Terms of the Offer. If the target firm's top managers and shareholders are happy with the terms of the transaction, they will go ahead with the deal.

Attempt to Negotiate. The tender offer price may not be high enough for the target company's shareholders to accept, or the specific terms of the deal may not be attractive. In a merger, there may be much at stake for the management of the target, particularly their jobs. If they're not satisfied with the terms laid out in the tender offer, the target's management may try to work out more agreeable terms that let them keep their jobs or, even better, send them off with a nice, big compensation package. Not surprisingly, highly sought-after target companies that are the object of several bidders will have greater latitude for negotiation. Furthermore, managers have more negotiating power if they can show that they are crucial to the merger's future success.

Execute a Takeover Defense or Find Another Acquirer. There are several strategies to fight off a potential acquirer (see Defensive Maneuvers, below).

Mergers and acquisitions can face scrutiny from regulatory bodies. For example, if the two biggest telecommunications companies in the U.S., AT&T and Verizon, wanted to merge, the deal would require approval from the Federal Communications Commission (FCC). The FCC would probably regard a merger of the two giants as the creation of a monopoly or, at the very least, a threat to competition in the industry.

3. Closing the Deal. Finally, once the target company agrees to the tender offer and regulatory requirements are met, the merger deal will be executed by means of some transaction. In a merger in which one company buys another, the acquiring company will pay for the target company's shares with cash, stock or both.

A cash-for-stock transaction is fairly straightforward: target company shareholders receive a cash payment for each share purchased. This transaction is treated as a taxable sale of the shares of the target company.

If the transaction is made with stock instead of cash, then it's not taxable. There is simply an exchange of share certificates. The desire to steer clear of the tax man explains why so many M&A deals are carried out as stock-for-stock transactions.

When a company is purchased with stock, new shares from the acquiring company's stock are issued directly to the target company's shareholders, or the new shares are sent to a broker who manages them for target company shareholders. The shareholders of the target company are only taxed when they sell their new shares.

When the deal is closed, investors usually receive a new stock in their portfolios – the acquiring company's expanded stock. Sometimes investors will receive new stock identifying a new corporate entity that is created by the M&A deal.

According to this information, we can conclude that process of M&A in Ukraine have a lot of positive and negative sides, to positive sides we can attribute:

The rationale behind a spinoff, tracking stock or carve-out is that "the parts are greater than the whole." These corporate restructuring techniques, which involve the separation of a business unit or subsidiary from the parent, can help a company raise additional equity funds. A break-up can also boost a company's valuation by providing powerful incentives to the people who work in the separating unit and help the parent's management to focus on core operations.

And to negative sides we can attribute.

That said de-merged firms are likely to be substantially smaller than their parents, possibly making it harder to tap credit markets and costlier finance that may be affordable only for larger companies. Additionally, the smaller size of the firm may mean it has less representation on major indexes, making it more difficult to attract interest from institutional investors.

Meanwhile, there are the extra costs that the parts of the business face if separated. When a firm divides itself into smaller units, it may be losing the synergy that it had as a larger entity. For instance, the division of expenses such as marketing, administration and research and development (R&D) into different business units may cause redundant costs without increasing overall revenues.

Process of M&A deals can hedge a lot of risks and can save business from different problems, such as hostile acquisitions, bankruptcy, high taxes and antitrust law. And of course it's providing synergy effect to companies who involved in M&A process.

Looking in turn at the prospects of market of MA development in Ukraine, it is possible to pay attention to that the last years, basic players at the investment market of Ukraine (large businessmen and companies), what it is created perspective enough climate for development of this sphere in Ukraine. We can pay attention, that most, investors pay attention, on the objects of the commercial real estate and production oriented to the export of products. Basic brake that stops development of investment climate and market of transactions of MA, it is even not war on east of Ukraine, and GDP that this year made less than to the 3 %, one of the largest present investors in Ukraine of Serhii Tihpko, that even on condition of firing in the center of city, but height of GDP in 7 % investors will invest in our country [6].

CONCLUSION

The Ukrainian M&A market is very small in volume but has very high prospects for development. Almost all transactions occurring on the market do not have enough transparency and are not satisfactory to international standards for the conduct of M&A transactions. For the sake of transparency in this market, there should be, for the first time, a method of honest valuation and audit, as well as an ethics of the operation of the merger and acquisition market. For fair valuation, there are various valuation strategies and methods that need to be implemented into the market, namely (DCF, Multipliers, Fundamental & Technical Analysis)

When entering into mergers, acquisitions or restructurings, companies should use methods of estimating future cash flows that in the future will generate profits and have a positive effect on the transaction and must choose the right strategy for the transaction in order to obtain the expected result from the process. Because a properly formulated goal will help you maximize the value of this agreement. It is also necessary to study the experience of foreign colleagues and to incorporate their experience into the day-to-day evaluation and formulation of an agreement strategy. To date, the M&A market is under development in Ukraine and forming the right expectations from this process will help not only maximize transactions, but also attract foreign investors with transparent agreements and market rules. DCF's main valuation method for companies today is universal for almost all companies and all transactions, as it helps to calculate future cash flows and to calculate the profitability the buyer can count on, given the historical financial statements of the companies. The method is not so perfect for valuing young companies that do not have public financial statements or have too little history in the market. Thus, to summarize, it can be concluded that a proper valuation of the company may not only affect the future agreement, but also on all activities in general, individual mergers and acquisitions, in the case of Ukraine may serve as green or red flags for foreign investors, and the more transparency the market will provide, the valuation of companies and the publicity of the process, the more attractive the Ukrainian economy will look to private investors. And choosing the right strategy can lead to efficiency, or not efficiency, in carrying out an agreement. At present, we can only observe the emergence of the M&A market in Ukraine, but the prospects that effective implementation into Ukrainian business realities can bring can help to develop the most efficient Ukrainian economy.

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