M&A

Moqi Groen-Xu

Cross-border acquisitions

Advantages of acquisitions versus greenfield investments:

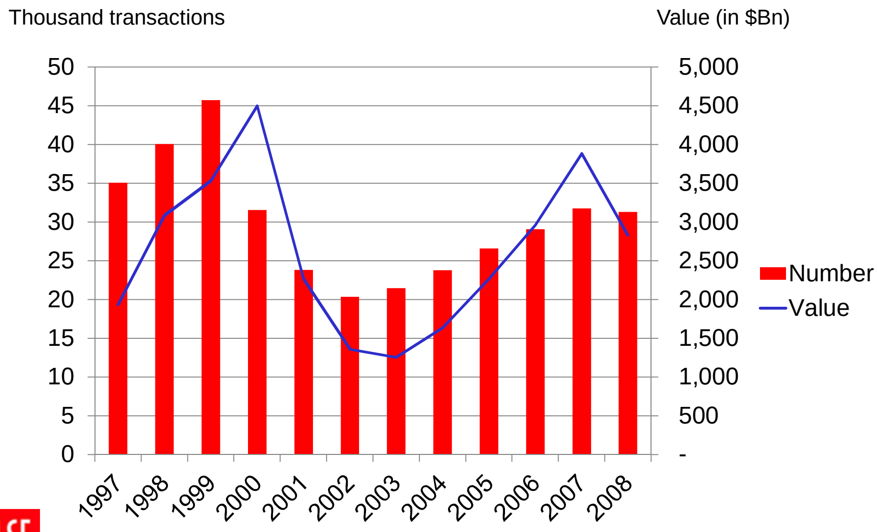
- Quicker
- Cost-effective way of gaining competitive advantages (technology, brands, logistical and distribution advantage)
- Market imperfections allow target firms to be undervalued (economic, political, and exchange rate conditions)

Cross-border acquisitions

Pitfalls:

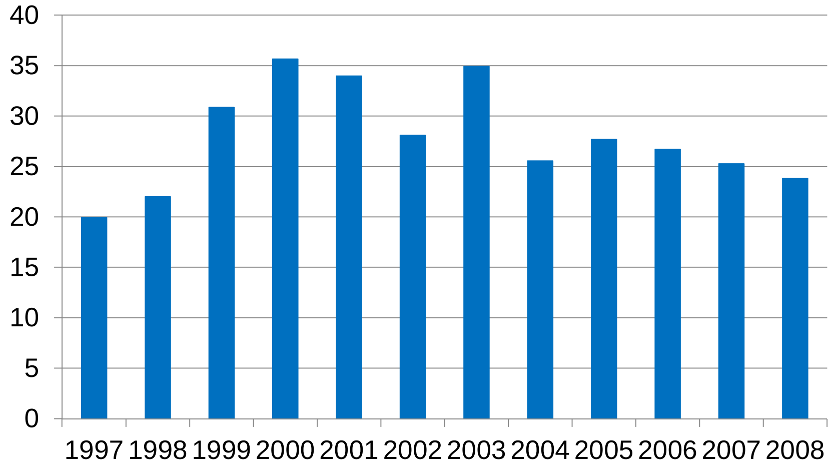
- Information asymmetry: price may be too high
- Corporate culture clashes
- Potential downsizing and loss of jobs
- Government intervention
- Fear of foreign ownership

Worldwide M&A (1997-2008)



Source : Thomson Financial (deals completed)

Average acquisition premium(1997-2008, US)



Source : Thomson Financial (deals completed), premium to stock price 4 weeks prior to announcement

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Merger Event Study

- Event window: A few days around the merger announcement.
- Market model: Estimate A and B's respective α and β over an estimation window, i.e., 120 days before the event window:

  $$R = \alpha + \beta \; R_m + \text{error term.}$$

- Estimate abnormal returns on each day of the event window:

  $$AR = R - (\alpha + \beta \; R_m)$$

- Cumulative abnormal returns (CAR):

  For A and B, sum up ARs over the event window.

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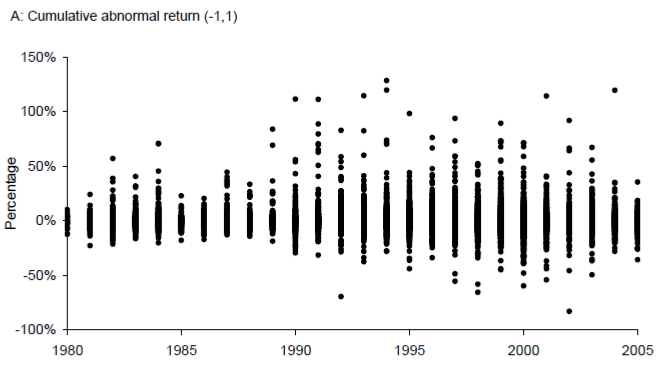
Merger Event Study (cont.)

- Bid premium:
  - in % terms = CAR_T.
  - in \$ terms per share = $CAR_T * p_T$.
  - In \$ terms for target (T) shareholders = $CAR_T * V_T$.

- Synergies:

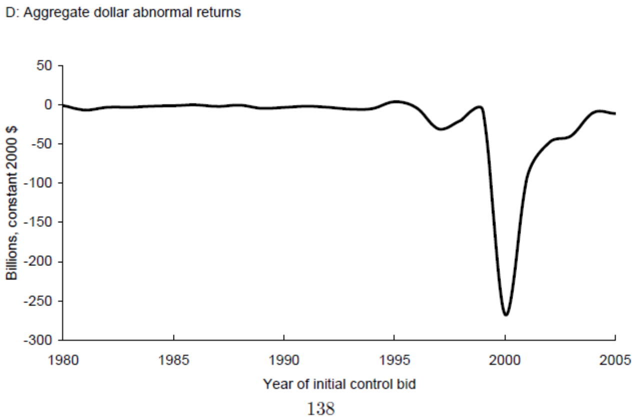
$$CAR_A * V_A + CAR_T * V_T$$

Acquirer announcement returns



Source: Betton, Eckbo and Thorburn: Corporate Takeovers

Acquirer announcement returns



Source: Betton, Eckbo and Thorburn: Corporate Takeovers

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Acquirer announcement returns

- Target shareholders are offered a premium and therefore gain from a takeover (10-50%)

- Bidder shareholders tend to be negative
  - Market reaction can contain other information about bidder
  - Bidders buying in cash instead of own shares experienced higher returns (again cash good and shares bad signals)
  - Bids can also provide (primarily positive) information about the target (targets on failed mergers trade at a premium)
  - What if the merger is anticipated?

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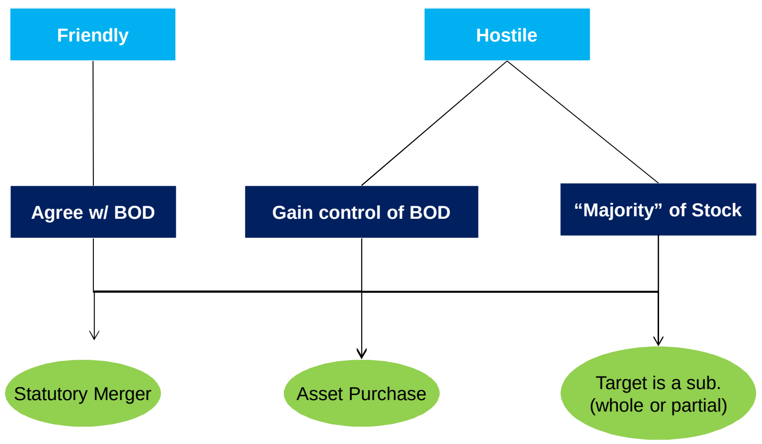
Control

Deal structure



Method 1:
Friendly Acquisition

- Negotiate with target's management in a "friendly environment".
- Both sides conduct their own valuation analysis.
- In principle:
  - Keep both Boards of Directors (BOD) informed.
  - Disclose that negotiations are taking place.
- BOD needs to approve ➔ Fairness opinion by I-bank or valuation specialist to assess the terms of the deal.

Method 1:
Friendly Acquisition (cont.)

- By far the most frequent acquisition method.
- This is the only possible method:
  - For privately owned firms.
  - For firms with a controlling shareholder.
- In most countries, most firms are tightly controlled (the typical firm is a family firm), even large publicly traded ones.

Method 2: Buy Majority of Stock

- Acquire enough shares to gain “Control”.
- How many shares? This varies across firms, countries, etc.
- How to go about it?
  - Private negotiation with a large shareholder.
  - Tender offer.
  - Creeping tender: Open market operation.

Private Negotiation

- Acquire a block of shares from an existing large shareholder (“Passing the Parcel”).
- Equal Treatment Rules (Mandatory Bid Rule) might force you to extend the offer to other shareholders.

Tender Offer

- Bypass the target's management and ask shareholders directly to sell (tender) their stock.
- Public announcement: "Will pay $55 per share!"
- Some terms and conditions:
  - 30 day period can be extended (esp. if offer is contested).
  - Conditional / Unconditional.
  - Payment in Cash/Shares/Both.
  - Restricted / Unrestricted.
  - Friendly / Hostile.

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Creeping Tender

- Acquire shares in the open market.
- May be illegal. Probably get dragged into court.
- Disclosure and Equal Treatment limit creeping tender.
- Why acquire a small block (Toehold)?

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Method 3:
Gain Control of Board of Directors

- Follow a complex series of tricky moves.
- Propose a slate of directors at annual shareholders' meeting.
- Vote (complicated rules).
- Majority of votes ➔ Your nominees win.
- If nominees constitute a majority of BOD ➔ "Control".

Method 3:
Gain Control of Board of Directors (cont.)

- Very few shares needed for this method (varies across firms).
- Cheaper than acquiring control by buying enough shares.
- But more time consuming and less likely to succeed.
- Sometimes do both.

Statutory Merger

- Combine Assets and Liabilities of the merging firms into new entity ("Successor liability").
- No need to renegotiate all contracts of employment, credit or to transfer each asset: It's automatic!

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Statutory Mergers: Important Remarks

- **Minority Squeeze Out (Freeze out).**
  - Merger requires vote of both sets of shareholders.
  - If approved, terms are binding for all shareholders.
  - Minority can to sue the company.
- **Assets and Liabilities: "Both Known and Unknown".**

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Asset Purchase

- The acquirer:
  - Buys selected assets.
  - Assumes selected liabilities.

- Usually vote to liquidate remaining assets and dissolve the target ➔ Proceeds are distributed to target shareholders.

- What are pros and cons w.r.t. purchase of stock?

Asset Purchase (cont.)

Remark 1:

- One way to evade some liabilities (including union contracts,…).
- Limited by Trust Fund Doctrine (and similar rules outside US).

Remark 2:

- Bidder may not have to gain approval of its shareholders.
- Usually, approval is necessary in equity deals and when there are not enough shares already authorized.

Remark 3:

- Sometimes incredibly high transactions costs.

Accounting

- **Pooling (merger) accounting:**
  - Assets and liabilities of the acquired company are carried forward at the “historical cost”.
  - Eliminated since 2001 in US.
- **Purchase (acquisition) accounting:**
  - The cost of the acquired company is assigned to the assets acquired and liabilities assumed.
  - The difference, if positive, is recorded as goodwill.
  - Goodwill amortized (written off) over up to 40 years +Tax deductible over up to 15 years.

Mode

XYZ's Tender Offer for ABC

- ABC has a dispersed ownership structure:
  - 10 million share outstanding.
  - Currently trading at $50 ➔ $500m market cap.
- XYZ considers gaining control of ABC to implement changes that would increase ABC's value to $600m ➔ Stock price $60.
- Tender-offer:
  - Conditional.
  - Cost: $3m.
  - What price?

The "Holdout" Problem

- If XYZ bids $51 per share, each small shareholder faces the following choice between tendering and not tendering.

	Value	
	if tender	if not
Bid succeeds	$51	$60
Bid fails	$50	$50

➔ The bid will fail and XYZ has lost $3m.

What's Happening?

- Each small shareholder rationally believes that her tendering decision has no effect on the offer's outcome.

➔ Don't tender unless the price reflects the full value improvement.

➔ In principle, any bid lower than $60 will fail!

➔ But then, how does XYZ cover the $3m cost?

- In practice: The holdout problem may be less extreme but still limit the acquirer's gain. ➔ Too few takeovers.

Solution 1: Toeholds

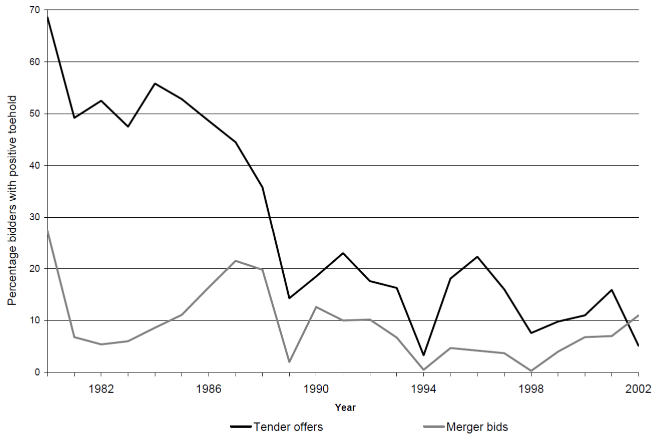
- XYZ has acquired a 10% toehold (i.e., 1 million shares) in ABC paying $50 per share in the open market.
- Will XYZ bid $60 per share?
- Say all remaining 9 million shares are tendered.

➔ Owns 100% of ABC worth (after changes) $600m.

- Paid 9m x $60 = $540m in the tender offer.
- Paid 1m x $50 = $50m for the toehold.

$600m - $540m - $50m - $3m = $7m >0!

The Toehold Puzzle



Source: Betton, Eckbo and Thorburn

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Solution 2: Two-Tiered Offers

- Controlling shareholder can force out minority shareholders at price deemed “fair”.
- Ambiguity ➔ Once in control, XYZ can force other shareholders to accept a payment (e.g. in securities) actually worth $53.
- Will a tender offer at $56 succeed?

	Value	
	if tender	if not
Bid succeeds	$56	$53
Bid fails	$50	$50

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Competition

- XYZ has made a two-tiered offer for ABC at $56.
- This alerts one of ABC’s existing blockholders to the possibility of improvements ➔ Counter-bid at $57.
- Where will this takeover contest converge? Depends on transaction costs

➔ XYZ loses $3m.

Solutions: No-shop agreements, break-up fees, etc.

Takeover Defenses

1. Preventative Measures

Poison Pills

- Usually, a kind of call option known as an “attached warrant” or “right” issued to existing shareholders deep out of the money.
- In most cases, the pill can be rescinded by directors.
- Over 1/3 of large US firms have poison pills of some kind.

Note: Also called “shareholder rights” plans.

Example: Flip-in Poison Pill

- ABC has a dispersed ownership structure:
  - 10 million share outstanding.
  - Currently trading at $50 ➔ $500m market cap.
- ABC's management fears becoming a target in a hostile bid.
- As a form of dividend, shareholders receive 5-year warrants for 2 shares of new stock at $500 per share.
- If any party acquires 20% or bids for 30% or more of the stock:
  - The strike price decreases to $10 per share.
  - But the acquirer/bidder cannot exercise.

Example: Flip-in Poison Pill (cont.)

- XYZ accumulates a 20% toehold:
  - 2 million shares at $50 ➔ $100m.
  - 8 million shares remain with other shareholders.
- Announcement triggers the change in the warrant's terms:
  - Everyone exercises their warrants ➔ 16m new shares.
  - ABC "raises" $160m ➔ Market cap increases to $660m.
  - Share price falls to 660m / 26m = $25.4
- What is the effect on XYZ?
  - Toehold is down from 20% to 2m/26m = 7.7%.
  - Value falls from $100m to 2m x $25.4 =$50.8m.

Shark Repellents

- Defensive corporate charter amendments.
- Generally require shareholders' approval, but not always.
- **Supermajority Provision:**
  - Supermajority (e.g., 67% for sometimes 90%) approval needed for transactions involving a change of control.
  - Board-out clause: Supermajority can be waived by BOD.
  - Fair Price Provision: Supermajority waived if bid exceeds a "fair" price (e.g., accounting based).

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Shark Repellents (cont.)

- **Staggered Boards:**
  - Each annual meeting, 1/3 of BOD is elected ➔ 2 annual meetings to get majority on BOD even w/ a majority of stock.
- **Authorization of Stock:**
  - BOD can issue securities (usually preferred stock) with multiple votes to "stable shareholders".

  ➔Reduces the bidder's voting power.
- **Voting Right Restrictions:** Limits "cumulative" voting rights.

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Anti-Takeover Laws

- Corporate lobbying:
  - In late 1980s, many US states passed anti-takeover laws.
  - Similar to stringent charter amendments.
  - Apply to all firms incorporated in that state.

➔ Choose state of incorporation strategically (Delaware).

2. Active Measures

Greenmail + Standstill Agreement

- A potential acquirer has an equity stake in the target.
- Greenmail payment + Standstill agreement:
  - The target buys the raiders' stake at a large premium.
  - The raider agrees not to raise his stake for a given period.
- **Note:** Also called Targeted Stock Repurchase.

Restructuring Assets/Liabs

Asset Restructurings:
- Sell some assets.
- Buy some assets.

Leveraged Recapitalizations or LBOs
➔ Less FCF problem.
➔ More concentrated ownership due to share repurchase.

- Do what the bidder would do ➔ Removes takeover motive.

Litigation

- Based on:
  - Antitrust or industry-specific regulation.
  - Inadequate disclosure.
  - Fraud.

- Very frequent (about 1/3 of tender offers).

- Effect:
  - Premium up by 17% if bidder persists.
  - But can also lead the bidder to withdraw the offer.

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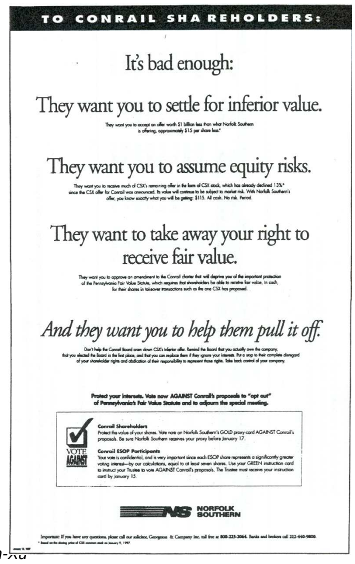
Press Campaigns



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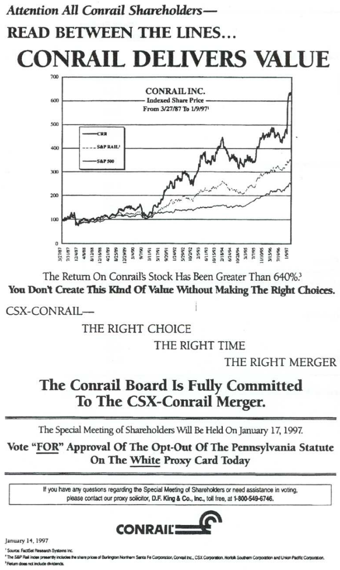
Press Campaigns



Some Other Defenses

White Knight Defense:

- The target finds a company to do a friendly merger.

White Squire Defense:

- The target finds a company to buy a big block.

Pac Man:

- "Eat or Be Eaten!": Target launches a counter-bid for the raider.

Why Takeover Defenses?

- Gain to target shareholders:
  - Successful takeovers ➔ >20%.
  - Unsuccessful takeovers ➔ Little if not eventually taken over.

- Why would target management resist a premium offer?
  - Entrenchment?
  - Bargaining strategy that might benefit shareholders?

Some Evidence

- Substantial stock price decline at announcement of:
  - Poison pill adoption.
  - Shark repellent.
  - Especially Supermajority and Staggered Board.
  - Greenmail offer and/or standstill agreement.
  - Anti-takeover legislation.

- Resistance closely tied to target management's financial stake.

Golden Parachutes

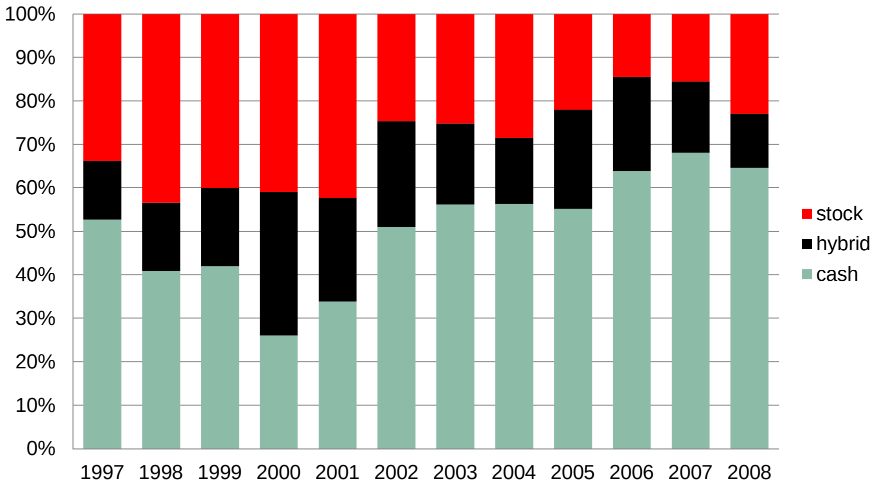
- Severance package to top management if fired due to takeover.
- Rationale: Avoid entrenchment by target management (Caveat: Won't they accept just any bid?).
- Stock price reaction: Target stock price rises 3% on the news that the firm is enacting a golden parachute.
- Why?
  - Golden parachute is small relative to the takeover gains.
  - The incumbent manager will now get out of the way.

Payment method

Method of Payment

- Cash: In most cases, purchase the equity and assume the debt.
- Stock:
  - A issues new shares to be exchanged against B shares.
  - Exchange Ratio = # A shares per B share.
  - Fixed shares vs. fixed value.
- A mix of both.
- Many other contractual arrangements:
  - Floor, Ceiling, etc.

Acquisition Finance (1997-2008, worldwide)



Source : Thomson Financial (volume, deals completed)

Method of Payment: Determinants

- Does the buyer have cash or can raise cash easily/cheaply?
- Does the seller need cash?
- Cash quicker:
  - No need for the seller to evaluate the offer.
  - The buyer might not need shareholder approval.
- Basic principle for taxes (for target shareholders):
  - Stock-for-stock deal ➔ Non-taxable transaction.
  - Cash or debt payment ➔ Taxable transaction.

Method of Payment: Determinants (cont.)

- Holding the offer value constant, increasing its cash component makes the offer value less sensitive to:
  - Synergies.
  - Standalone value of acquirer.
  - Standalone value of the target.

➔ Cash/stock mix affects:
  - Risk allocation between acquirer and target shareholders.
  - Value allocation if value estimates differ, e.g., pay cash if you think that the target is undervalued.

- Means of payment can affect perception and actual integration: Who buys whom? Merger of equals?

Financing

- Should be driven by debt capacity of Buyer + Target. See capital structure lecture

- Be careful:
  - It is always possible to increase leverage later.
  - It can be too late to reduce leverage!
  - Particularly important if you consider further acquisitions.