Mergers and Acquisitions

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Outline

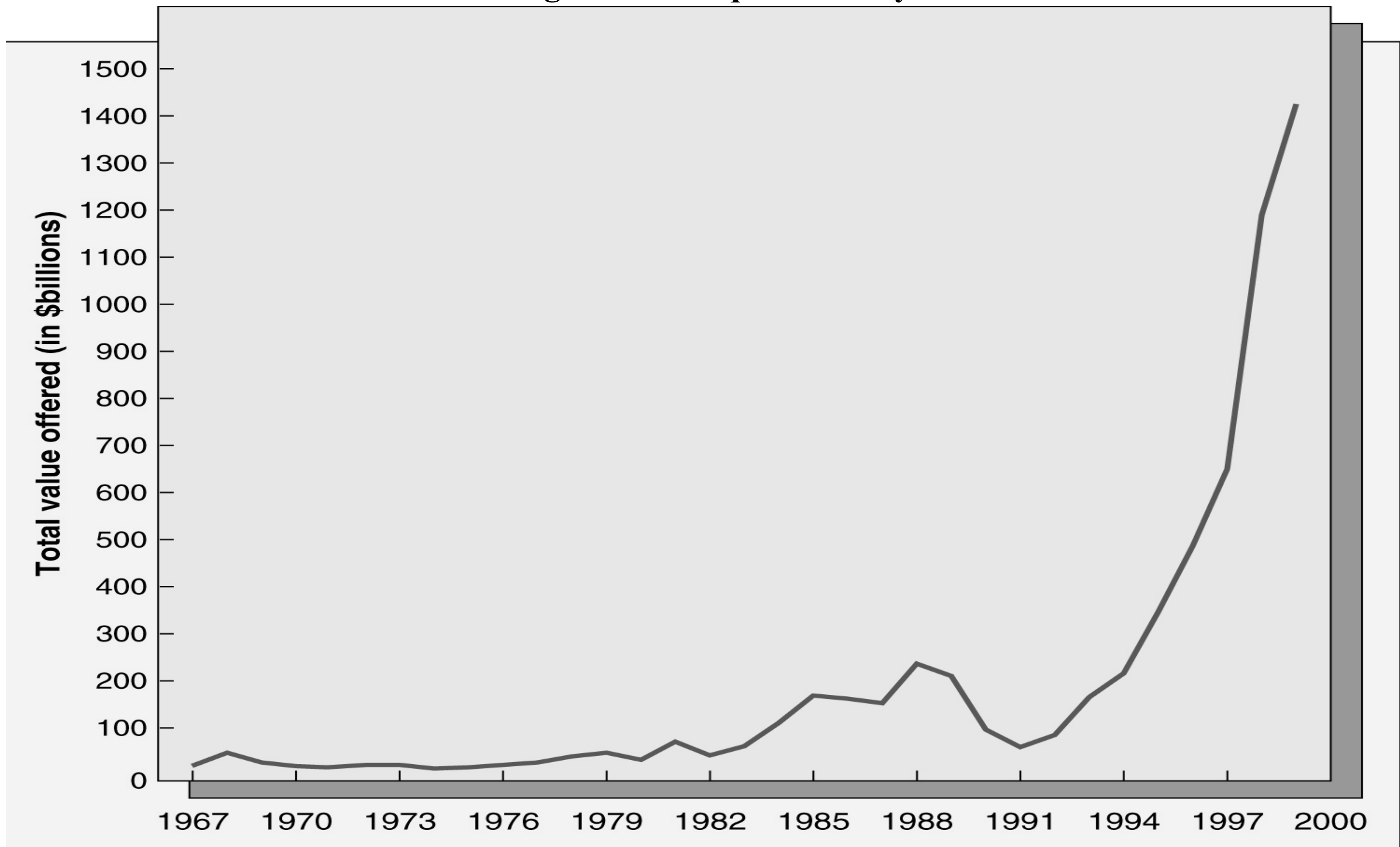
- A history of mergers and acquisitions
- Sources of takeover gains
- The disadvantages of mergers and acquisitions
- Empirical evidence on takeover gains
- Bidding and defending strategies in hostile takeovers

A History of Mergers and Acquisitions

- Exhibit 20.1 Dollar volume of mergers and acquisitions by year
- The emergence of the high-yield, junk bond market in the 1980s
- Deregulation in transportation, communication, and financial services
- Exhibit 20.2 Largest mergers in history
- Types of acquisitions

Types	Primary motivation	Hostile or friendly	Trend
Strategies	Operating synergies	Usually friendly	In the 1990s
Financial	Taxes, incentives	Often hostile	Mainly in the 1980s
Conglomerate	Financial synergies, taxes, incentives	Hostile/friendly	Mainly in the 1960s, 70s

Exhibit 20.1: Dollar Volume of Mergers and Acquisitions by Year



Source: *Mergerstat Review* and W. T. Grimm.

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Exhibit 20.2: Largest Mergers in the Last Millennium

Buyer	*Seller*	*Price Offered (Millions)*	*Year Announced*
Pfizer	Warner-Lambert Co.	$82.399.6	1999
Exxon	Mobil Corp	$81,429.8	1998
SBC Communications	Ameritech Corp	$75,233.5	1998
Vodafone Group	AirTouch Communications	$62,768.0	1999
British Petroleum Co	Amoco	$56,482.0	1998
AT&T	MediaOne Group	$55,795.4	1999
Bell Atlantic	GTE	$52,845.8	1998
AT&T	Tele-Communications	$52,525.6	1998
NationsBank	BankAmerica	$43,158.3	1998
WorldCom	MCI Communications	$42,459.2	1997
Travelers Group	Citicorp	$36,031.6	1998
Qwest Communications Intl	US West Inc.	$34,748.0	1999
Viacom	CBS	$34,454.0	1999
Norwest	Wells Fargo & Co.	$31,660.2	1998
Daimler Benz	Chrysler	$31,156.0	1998

Source: *Mergerstat Review*.

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- Friendly/hostile takeover, offer made to (bypassing) to management
- A strategic acquisition involves operating synergies, meaning two firms are more profitable combined than separate
- In a financial acquisition, the bidder believes that the price of the target's stock is less than the value of its assets, perhaps because of bad management
- Conglomerate acquisition involves firms with no apparent operating synergies
- Very few hostile takeovers and LBOs in the 1990s, but the number and size of cross-border mergers have increased substantially

Sources of Takeover Gains

- Operating synergies, the uniting of two firms improve productivity or cut costs so that the unlevered cash flows of the combined firm exceed the combined unlevered cash flows of the individual firm

- A vertical merger between a supplier and a customer, eliminates various coordination and bargaining problems

- A horizontal merger between competitors, produces a less competitive product market and cost savings from combining R&D facilities and sales forces

- Financial synergies
- Information and incentive problems may cause cash-starved firms to pass up positive NPV projects, but cash-rich firms to overinvest in negative NPV projects
- Conglomerates can use internal capital markets to transfer funds from negative NPV projects to positive NPV projects
- Result 20.4 The advantages of diversification:
  - Enhance the flexibility of the organization
  - Avoid some incentives problems in external capital markets
  - Reduces bankruptcy risk
  - Hide proprietary information

The disadvantages of diversification:

- Eliminate information in stock price, relevant to compensate division heads
- Subsidize losers out of profits from winners

■ What is the optimal size of a firm?

Empirical Evidence on Takeover Gains

- Does takeover create value? Stock return, firm value, profitability
- Stock returns around the time of takeover announcements
- Stock price reaction to takeover bids are as follows:
  - The stock return of the target almost always reacts favorably by 16–50%
  - The bidder's stock price can go up or down
  - The combined market values of the shares of the target and bidder go up by 7.4%, on average

- The bidder's stock price reacts more favorably when the bid is financed by cash rather than equity (through an offer to exchange stocks)
- Stock prices tend to decline subsequent to the failure of an initial bid, but the prices stay considerably above the stock price for the target before the bid
- Diversification discount, the market places lower values on more diversified firms
- Lang and Stulz (1994), Berger and Ofek (1995)
- The magnitude of the discount is lower the more concentrated the ownership, Denis, Denis, and Sarin (1997), the discount partially reflects overinvestment
- More mixed evidence on post-merger productivity

Bidding Strategies

- Grossman and Hart (1980), the free-rider problem: if shareholders are all small, none will find it in their interests to go to the expense of replacing a non-value-maximizing management
- Can a large shareholder overcome this free-rider problem?
- The bidder's ability to take over a target at a price that allows the bidder to offset his costs depends on how the bidder treats those shareholders who refuse to sell their shares

- A conditional tender offer is an offer to purchase a specific number of shares at a specific price, but the buyer is not required to purchase if the specific number of shares is not tendered

- Example 20.4 Alpha Corporation sells for $20 per share, Douglas believes he can raise it to $30 per share under his management, makes a conditional tender offer for 51% of the outstanding shares at $25 per share that contains a premium of $5 per share. Will the offer be successful?

- From the small target shareholders' perspective,

	Payoff if tender	Payoff if not
Bid succeeds	$25 per share	$30 per share
Bid fails	$20 per share	$20 per share

- So don't tender

- Small shareholders will not tender their shares if they are offered less than the post-takeover value of the shares. As a result, takeovers that could potentially lead to substantial value improvements may fail

- Solution 1: Buying shares secretly on the open market

- SEC requires any bidder to state their intentions as soon as their holdings reach 5% of outstanding shares

- Example 20.5 Continue with Example 20.4, Alpha has 10 million shares outstanding, the costs of mounting the takeover are $4 million. Can Douglas take over Alpha profitably?

- Douglas can buy 5% of shares for $20 per share.

- Afterwards he has to make a tender offer for the remaining 46% for \$30 per share, no profits from this 46%
- But \$10 per share for 0.5 ($5\% \times 10$) million shares, \$5 mil profits > \$4 mil costs
- Solution 2: Secret share accumulation by risk arbitrageurs
- Large shareholders who could affect the success or failure of the offer will be willing to tender their shares at a price below their post-takeover value
- Example 20.6 Suppose Joe has 15% of Alpha stock following Douglas's tender offer at \$26 per share. If Joe tenders, the offer will succeed, if not, the offer has a 50% chance. Should Joe tender?
- Tendering gets \$26 per share; otherwise gets \$25 ($.5 \times 20 + .5 \times 30$). Tender!

- Solution 3: There are gains captured directly by the bidder
- If the bidder values control of the firm, he can place a value on the shares he acquires that exceeds the post-takeover value to target shareholders
- Example 20.7 Suppose part of $30 per share comes from selling its R&D division to Beta corporation also owned by Douglas. Otherwise, the post-takeover value of Alpha is only $27 per share
- Realizing the post-takeover price is $27 per share, shareholders will tender at $27. Douglas makes $3 per share profits from the price appreciation of Beta
- Solution 4: Two-tiered offers, the bidder offers a price in the initial tender off for a specified number of shares and simultaneously announces plans to acquire the remaining shares at another, lower price in a follow-up merger

- In almost all cases, cash is used in the tender offer but securities, worth less than the cash offered in the first-tier offer, are offered in the second tier

- Shareholders are thus coerced to tender their shares to the bidder

- Example 20.8 Buccaneers Inc has made a $25 per share tender offer for 51% of Purity Corporation. If successful, the shares not tendered in the first tier will receive a combination of bonds and preferred stock at $22 per share. You believe the shares are worth $30 per share and would like the takeover to fail, tender?

- Assume you are a small shareholder, payoffs are

	tender	not tender
Bid succeeds	$25 per share	$22 per share
Bid fails	$30 per share	$30 per share

- Tender.

Defense Strategies

- Greenmail, buying back the bidder's stock at a substantial premium over its market price on condition that the bidder suspend his or her bid
- Supermajority rule, a change in control requires shareholder approval by at least a two-thirds vote and sometimes as much as 90 percent of the shares
- Staggered boards, board members are often elected to three-year terms, so that only one-third of the board members are elected in any given year
- Poison pills, rights or securities that a firm issues to its shareholders, giving them valuable benefits in the event that a significant number of its shares are acquired

- All poison pills involve a wealth transfer from the bidder to shareholders who do not tender their shares, thus increasing the costs of acquisition
- Flipover rights plan, target shareholders receive the right to purchase the acquiring firm's stock at a substantial discount in the event of a merger
- Antitakeover laws
- Are takeover defenses good for shareholders?
- Keep entrenched managers in power, but raise the offer for target shareholders
- Mixed evidence