Mergers and Acquisitions

Topics

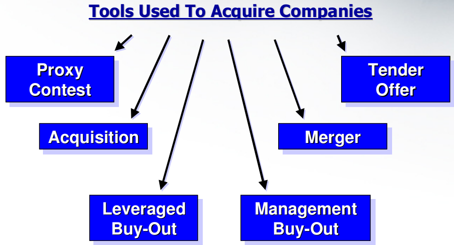
- Market for Corporate Control
- Motives & Reasons for Mergers
- Merger Tactics
- Merger Regulations
- Evaluating Mergers
- Leveraged Buy-Outs

Merger/Takeover Market

- Methods to Change Management
  - Proxy battle for control of the board of directors
  - Firm purchased by another firm
  - Leveraged buyout by a group of investors
  - Divestiture of all or part of the firm's business units

Merger Market

Tools Used To Acquire Companies



Role of Investment Banker

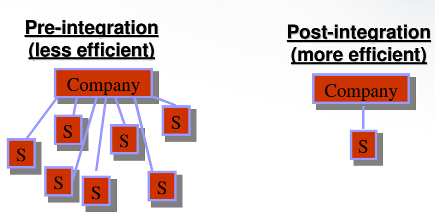
- Help arrange mergers.
- Help target companies develop and implement defensive tactics.
- Help value target companies.
- Help finance mergers.
- Speculate in the stocks of potential merger candidates.

Sensible Reasons for Mergers

- Economies of Scale
  - A larger firm may be able to reduce its per unit cost by using excess capacity or spreading fixed costs across more units.
- Mergers as a Use for Surplus Funds
  - If your firm is in a mature industry with few, if any, positive NPV projects available, acquisition may be the best use of your funds.
- Economies of Vertical Integration
- Combining Complementary Resources

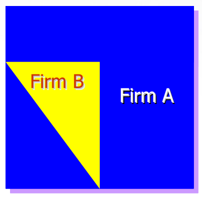
Sensible Reasons for Mergers

- **Economies of Vertical Integration**
  - Control over suppliers "may" reduce costs.
  - Over integration can cause the opposite effect.



Sensible Reasons for Mergers

- **Combining Complementary Resources**
  - Merging may results in each firm filling in the “missing pieces” of their firm with pieces from the other firm.



Dubious Reasons for Mergers

- Diversification
  - Investors should not pay a premium for diversification since they can do it themselves.
- The Bootstrap Game
  1. Acquiring Firm has high P/E ratio & selling firm has low P/E ratio (due to low number of shares)
  2. After merger, acquiring firm has short term EPS rise.
  3. Long term, acquirer will have slower than normal EPS growth due to share dilution.

Defensive Tactics

- Target-firm managers frequently resist takeover attempts.
- It can start with press releases and mailings to shareholders that present management’s viewpoint and escalate to legal action.
- Management resistance may represent the pursuit of self interest at the expense of shareholders.
- Resistance may benefit shareholders in the end if it results in a higher offer premium from the bidding firm or another bidder.

Merger Jargons & Tactics

- **Shark Repellent**: Amendments to a company charter made to forestall takeover attempts. (e.g. Supermajority rule)
- **Poison Pill**: Measure taken by a target firm to avoid acquisition; e.g. the right for existing shareholders to buy additional shares at an attractive price if a bidder acquires a large holding.
- **Crown Jewels**: Major assets of the target. If the target firm management is desperate enough, they will sell off the crown jewels.
- **Golden Parachutes**: Compensation to outgoing target firm management.
- **White Knight**: Friendly potential acquirer sought by a target company threatened by an unwelcome suitor.
- **Greenmail**: In a targeted repurchase, the firm buys back its own stock from a potential acquirer, often at a premium.

Merger Regulation

- Prior to the mid-1960s
  - Mainly friendly acquisitions using stock-exchange
  - Proxy fight for hostile takeovers
- In the mid-1960s
  - Raiders increasingly use tender offers
  - Institutional investors

Williams Act in 1968

- Put target managements in better position
  - A raider must disclose his holdings and future intentions within 10 days of amassing at least 5% of total shares.
  - The offer must be open 20 days.
  - If tender price is renewed higher, all shareholders who tendered prior to the new offer must receive the higher price.
  - More time for defense, competing bidders and white knights.

State Laws

- Many states enacted anti-takeover laws in 1970s.
- 1979 MITE Corp. (Delaware) vs Chicago Rivet and Machine Co. (Illinois)
  - Supreme Court ruled the Illinois Business Takeover Act unconstitutional, because it put undue burdens on interstate commerce.

State Laws

- Indiana law
  - When an investor buys control shares (20%), those shares can be voted only after approval by a majority of "disinterested shareholders," defined as shareholders who are not officers or inside directors of the company and associates of the raider.
  - The buyer of control shares has the right to insist for a shareholders' meeting within 50 days to decide whether the shares may be voted.
  - Limits on the use of golden parachutes, onerous debt-financing plans and some types of poison pills.

Evaluating Mergers

- Questions
  - Is there an overall economic gain to the merger?
  - Do the terms of the merger make the company and its shareholders better off?

PV(Company A) + PV(Company B) < PV(AB)

Evaluating Mergers

- Typically, a firm would use NPV analysis when making acquisitions.
  Estimated net gain
  = DCF valuation of target including synergies
    – Cash required for acquisition
- Avoiding Mistakes
  - Do not Ignore Market Values
  - Estimate only Incremental Cash Flows
  - Use the Correct Discount Rate
  - Don't Forget Transactions Costs

Merger/Takeover Premium

- Hypothesized sources of target value increase
  - Synergy hypothesis
    - Improved operating efficiency
    - Market power
  - Information hypothesis
    - Sitting on a gold mine
    - Kick in the pants

Merger Results

- Most acquisitions fail to create value for the acquirer.
- The main reason why they do not lies in failures to integrate two companies after a merger.
  - Intellectual capital often walks out the door when acquisitions aren't handled carefully.
  - Traditionally, acquisitions deliver value when they allow for scale economies or market power, better products and services in the market, or learning from the new firms.
- Management Hubris?

Leveraged Buy-Outs

- Unique Features of LBOs

Large portion of buy-out financed by debt

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Shares of the LBO no longer trade on the open market

Management Buy-Outs

- Hypothesized Sources of Value in MBOs
  - Information advantage (Underpricing) hypothesis
  - Reduced agency costs (Improved incentive) hypothesis