Chapter 20: Mergers and Acquisitions

A *merger* is a transaction that combines two organizations into one new organization. An *acquisition* is the purchase of one organization by another organization. In some cases, two organizations are combined into one and one less stock is publicly traded. In others, such as leveraged buyouts (LBOs), there is a transfer of ownership of a single organization. The terms are often used interchangeably.

In most cases the parties in a merger can be classified as an *acquiring organization*, which bids on the target, and a *target organization*, which receives the offer. In most cases, the acquiring organization offers to buy the target's shares at a premium over the target's prevailing stock price. This premium is called the *takeover premium*.

Mergers and acquisitions are categorized in three categories:

1. *Strategic acquisition*: this acquisition involves operating synergies, which means that the two organizations are more profitable combined than they are separately.
2. *Financial acquisitions*: This is an acquisition that has no operating synergies. In this type of acquisition the bidder believes that the price of the stock is fewer than the value of the assets.
3. *Conglomerate acquisition*: This type of acquisition involves organizations with no apparent potential for operating synergies. This is similar to the financial acquisition, but there are financial synergies here, which decrease the costs of capital.

Mergers only produce operating synergies when productivity is improves or when the costs are decreased. There are several potential sources for operating synergy.

A *vertical merger* which is a merger between a supplier and a customer, can solve coordination and bargaining problems between the supplier and the customer. A *horizontal merger*, which is a merger between competitors, can result in cost reductions. Additional operating synergies arise when the merged form can benefit from the ability to transfer resources from one division to another.

Disciplinary takeovers are usually hostile, often lead to the breakup of large diversified corporations, and result in job losses for a number of the target organization's top managers.

For these reasons, disciplinary takeovers are more controversial than synergy motivated acquisitions. They are particularly controversial when the acquirer, often referred to as the *raider*, is a relatively thinly capitalized individual or organization seeking to acquire a much bigger enterprise using debt financing.

These take-overs are normally structured as leveraged buy-outs (LBO's). This has also been used, by the top managers of organizations, who wish to buy out their own organization and take them private, referred to as *management buyout (MBO).* The organization's top management stays the same after a MBO.

The relation between hostile takeovers and employee layoffs may reveal the need for a different type of manager at different stages of a corporation's growth. Takeovers can be a symptom of as well as a cure for managerial inducement problems.

For example, managers in declining industries may want to protect their jobs by acquiring organizations in industries with improved long-term prospects.

In addition, some managers may want to manage bigger enterprises, and the takeover market may be the most expedient way to accomplish this goal.

Since diversification reduces the risk of bankruptcy for any given level of debt, it can raise the amount of debt in the organization's optimal capital structure, which in turn can lower the organization's cost of capital. Financial synergies can also arise because of the personal taxes on cash distributions. Personal taxes can be avoided if two organizations merge.

Conglomerate can provide funding for investment projects that independent organizations would not have been able to fund using outside capital markets. To the extent that positive NPV projects receive funding they would not have otherwise received, conglomerates create value.

To evaluate the benefits of an acquisition, a financial analyst needs to do more than compare the costs and benefits of combining two organizations with the current situation where the two organizations have no relationship. The executives in the two companies should investigate whether the gains from combining the organizations can be achieved more efficiently in some other way. One must consider whether the achieving financial and operating synergies requires them to emerge.

The preceding described a number of benefits associated with mergers and acquisitions, but there can also be offsetting disadvantages.

The prevailing view of mergers has changed substantially over time. Shareholders and analysts have become more cynical about gains from M&A and more aware of the potential downside of combining two organizations.

Combining two organizations can destroy value if the managers of the combined organization use the added flexibility to transfer resources between the two organizations to subsidize money-losing lines of businesses that would otherwise be shut down. Subsidization of this sort is likely to arise, if the organization's top management is unwilling to cut jobs or has other reasons to keep a losing business in operation.

When two organizations combine, there is usually one less publicly traded stock. This can create a cost if stock prices convey information that helps managers to allocate resources.

Summarized the advantages of diversification can be described as follows:

- Diversifications enhances the flexibility of the organization;
- The internal capital markets avoids some of the information problems inherent in an external capital market;
- Diversification reduces the probability of bankruptcy for any given level of debt and raises the organization's debt capacity;
- Competitors find it more hard to uncover proprietary information from diversified organizations;
- Diversification is advantageous if it allows the organization to utilize its organization more effectively.

Summarized the advantages of diversification can be described as follows:

- Diversification can remove a valuable source of information which may, among other things, make it hard to compensate the division heads of large diversified organizations efficiently.
- Managers may find it hard to cut back optimally on losing divisions, when they can subsidize the losers out of the profits from their winners.

Adding the bidder and target return entails that, on average, there is a net gain to shareholders around the time of the merger announcement.

Stock price reactions to takeover can be described as follows:

- The stock prices of target organizations almost always react favorably to merger and tender offer bids;
- The bidder's stock price sometimes goes up and sometimes goes down, depending on the circumstances;
- The combined market values of the shares of the target and bidder go up, on average, around the time of the announced bids.

The stock returns of the bidder at the time of the announcement of the bid tells us more about how the market is reassessing the bidder's business than it does about the value of the acquisition. Indeed, stock prices may react favourably to the announcement of an acquisition, even when shareholders believe the acquisition harms shareholders.

The bidder's stock price reacts more favourably, on average, when the bides makes a cash offer rather than an offer to exchange stock. This may reflect the relatively negative information about the bidder's existing business by the offer to exchange stock.

If the financial markets believe that a bidder has special information about a target, then a bid also is likely to convey information to the market about the value of the market as a stand-alone company. One can acquire insights about the extent to which special information about a target is revealed by examining stock price reactions when offers are terminated. Share prices tend to decline subsequent to the failure of an initial bid, but the prices usually stay considerably higher than the stock price for the target that existed before the bid.

This evidence could point out that the bidders have some special information because, if the gains were all due to either improved management or synergies, the stock price theoretically should drop back to its original level after a failed bid.

Cash flows often improve after LBO's. The reasons for this are:

- Productivity gains;
- Initiation of LBOs by organizations with improving prospects;
- The inducements of leveraged organizations accelerate cash flows, sometimes at the expense of long-run cash flows.

Assuming risk neutrality and a zero discount rate, we can express the organization's currents stock price as: current operating value + (expected takeover premium) x (takeover probability).

Organizations can value a target by following the following steps:

1. Value the target as a stand-alone organization;

2. Calibrate the valuation model;

3. Value the synergies;

4. Value the acquisition;

When managers are considering the way to finance a project, one should also consider the following:

1. Tax implications;

2. Accounting implications;

3. capital structure implications;

4. Information effects.

Small shareholders will not sell their shares if they are offered less than the post-takeover value of the shares. As a result takeovers that could create substantial value improvements may fail. An *unconditional or an any-for-all offer* may purchase the tendered shares even if the organization fails to attract enough tendered shares to gain control of the organization.

Strategies to avoid a takeover:

- Paying *greenmail* or buying back the bidder's stock at a substantial premium over its market price on condition that the bidder suspend his or her bid;
- Creating *staggered board terms and supermajority rules*, which can keep a bidder from taking over the organization even if he or she accumulates more than 50% of the target's organization shares.
- Introducing *poison pills*, which provide valuable rights to target shareholders who choose not to tender their shares.
- Lobbying for anti takeover legislation.