Chapter 22: Mergers and acquisitions

Introduction

Mergers and acquisitions are part of what is often referred to as “the market for corporate control”.When one firm acquires another, there is typically a buyer (acquirer or bidder) and a seller, called a target firm.

- The acquirer is the firm that, in a takeover buys another firm.
- Target firm is the firm that is acquirer by another in a merger or acquisition.

A takeover refers to two mechanisms, either a merger or an acquisition, by which ownership and control of a firm can change. Globally there are nowadays many takeovers.

Merger waves: Peaks of heavy activity followed by quiet troughs of few transactions in the takeover market. During economic expansions merger activity is greater than during economic contractions. The same economic factors that drive economic activity likely also drive peaks in merger activity.

There are different types of mergers:

- Horizontal merger: the type of merger when the target and acquirer are in the same industry.
- Vertical merger: The type of merger when the target’s industry buys or sells to the acquirer’s industry
- Conglomerate merger: The type of merger of when the target and acquirer operate in unrelated industries

Deals also vary based on whether the target shareholders receive stock or cash as payment for target shares. When the shareholders receive stock as payment for target shares it is called a stock swap.

Term sheet is also an important aspect for a merger. It is a summary of the structure of a merger transaction that includes details as who will run the new company, the size and composition of the new board, the location of the headquarters, and the name of the new company.

Market reaction

Most acquirers pay a substantial acquisition premium: This is a paid by an acquirer in a takeover and is the percentage difference between the acquisition price and the premerger price of a target firm.

Acquire reasons

The basis of the assumption that the value of the combined companies will be worth more than the sum of the two companies individual values is the assumption that they will create synergies.

Synergies: Value obtained form an acquisition that could not be obtained if the target remained an independent firm. Some examples of synergies:

1. Economies of scale and scope

- Economies of scale: The savings a large company can enjoy from producing goods in high volume, that are not available in a small company.
- Economies of scope: Savings large companies can realize that come from combining the marketing and distribution of different types of related products.

2. Vertical Integration

Vertical integration refers to the merger of two companies that make products required at different stages of the production cycle for the final good. Also refers to the merger of a firm and its supplier or a firm and its customer. The principal benefit of vertical integration is coordination. If two companies are under central control, one can ensure that both work toward the same goal.

3. Expertise

Firms often need expertise in particular areas to compete efficiently. By mergers or acquisitions firms achieve more expertise. In this situation a firm can enter a labor market and attempt to hire personnel with the required skills.

4. Monopoly gains

When there are not many firms in the market there is more power for the firm as a monopoly because there is less competition. The costs of a monopoly are on society and therefore most countries have antitrust laws that limit monopoly activity.

5. Efficiency gains

Takeovers relying on the improvement of target management are difficult to complete and post-takeover resistance to change can be great. Thus not all inefficiently run organizations necessarily become more efficient following a takeover.

6. Tax savings from operating losses

When the firm makes profits it must pay taxes over it. However, the firm does not gave to pay taxes over losses. So a conglomerate has a tax advantage, since losses in one division can be offset by profits in another division.

7. Diversification

Diversification has 3 benefits:

- Direct risk reduction
- Debt capacity and borrowing costs
- Liquidity enhancement

8. Earnings growth

It is possible to combine two companies with the result that the earnings per share of the merged company exceed the premerger earnings per share, even when the merger itself creates no economic value!

9. Managerial motives to merge

Sometimes managers have their own motives to merge. On average the stock price of large bidders drops when a bid is announced. There are two possible explanations for this±

- Conflicts of interest between managers and shareholders
- Overconfidence of managers

Takeover process

Once the acquirer has completed the valuation process, it is in the position to make a tender offer! That is a public announcement of its intention to purchase a large block of shares for a specified price.

Important in a stock-swap transaction: The bidder pays for the target by issuing new stock and giving it to the target shareholders. The price offered is determined by the exchange ratio. In a takeover the exchange ratio is the number of bidder shares received in exchange for each target share.

Exchange ratio < PT/PA * (1+ S/T)

Pt = price target share

Pa = Price aquirer share.

S=value of the synergies created by the merger

T = premerger value of the target.

Once an offer is announced there is no guarantee that the takeover will actually take place. Often acquirers have to raise the price to make the deal.

Risk arbitrageurs: Traders who, once a takeover offer is announced, speculate on the outcome of the deal. They believe that they can predict the outcome of the deal.

Merger- arbitrage spread: In a takeover, the difference between a target's stock price and the implied offer price. However it is not a true arbitrage opportunity because there is a risk that the deal will not go through.

Step up refers to an increase in the book value of a target's assets to the purchase price when an acquirer purchases those assets directly instead of purchasing the target stock.

For a merger to precede both the target and the acquiring board of directors must approve the deal and put the question to a vote of the shareholders.

- Friendly takeover: When a target's board of directors supports a merger, negotiates with potential acquirers and agrees on a price that ultimately put to a shareholder vote
- Hostile takeover: A situation in which an individual organization, sometimes referred to as a corporate raider, purchases a large fraction of a target corporation's stock and in doing so gets enough votes to replace the target's board of directors and its CEO. The acquirer in a hostile take over is called a corporate raider.

Takover defenses

For a takeover to succeed, the acquirer must go around the target board of directors and appeal directly to the target shareholders. The acquirer will usually do this with a proxy fight.

Proxy fight: The acquirer attempts to convince target shareholders to unseat the target´s board by using their proxy votes to support the acquirers candidates for election to the target board.

The most effective defending strategy is the poison pill: A defense against a hostile takeover, it is a rights offering that gives the target shareholders the right to buy shares in either the target or a n acquirer at a deeply discounted price.

Some other defending strategies are:

- Staggered boards: Board of directors whose three years terms are staggered, so that only one-third of the directors are up for election each year
- Golden parachute: An extremely lucrative severance package that is guaranteed to a firm's senior managers in the event that the firm is taken over and the managers are let go.
- White knights: Target Company's defense takeover attempt, it looks for a friendlier company to acquire it.
- White squire: A variant of white knight. It agrees to purchase a substantial block of shares in a target with special voting rights.
- Recapitalization: A company changes its capital structure to make itself less attractive as a target.

All mergers mus be approved by regulators. Many countries have antritrust regulations to limit mergers and acquisitions.

Value added from takeover

When a bidder makes an offer for a firm, the target shareholders can benefit by keeping their shares and letting other shareholders sell at a low price. However, because shareholders have the incentive to keep their shares, no one will sell.

This scenario is known as the free rider problem. To overcome this problem, bidders can acquire a toehold in a target, attempt a leverage buyout or in the case when the acquirer is a corporation, offer a freezeout merger.

A toehold is an initial ownership stake in a firm that a corporate rider can use to initiate a takeover attempt.

Some legal mechanisms that exist to avoid the free rider problem and profit most from the gains from an acquisition are a leveraged buyout and a freezout merger.

A management buyout (MBO) is a leveraged buyout in which the buyer group includes the firm's own management.

A freezeout merger is a situation in which the laws on tender offers allow an acquiring company to freeze the existing shareholders out of the gains from merging by forcing nontendering shareholders to sell their shares for the tender offer price.