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Advice in mergers & acquisitions

- Mergers and acquisitions is one of the main divisions of investment banks and one of the most profitable businesses in investment banking.
- It importance in terms of the revenue it generates will vary widely between different investment banks, with some investment banks only providing very little advice in this area, while for other investment banks it is the main source of income.
- Mergers and acquisitions is also an area that is popular with investment bankers themselves, it has a high prestige to be employed in this area and the remuneration is high as well. It will, however, come with a high workload and long hours.
- We will explore in this topic the advice investment banks give their clients in mergers and acquisitions, focussing especially on any conflicts of interest between the investment bank and their client.

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The role of investment banks in mergers & acquisitions

- Investment banks provide advice to companies seeking to merge with another company, acquire another company, or being acquired by another company, whether willingly or unwillingly
- The processes and specific tasks are different for each type of transaction, the principle remains the same
- Investment banks will in particular advise on the valuation of their own company and that of the other company involved
- Investment banks will also advise on reactions by capital markets to the merger, such as the likely reception by shareholders of a proposed merger
- Investment banks will advise on the strategy of making and accepting offers
- Investment banks only provide advice, they do not take a stake in any of the companies involved

The role of investment banks in mergers & acquisitions

→ Mergers and acquisitions, short a merger, encompass a wide variety of transactions in which two companies are joined. Investment banks are involved in most mergers that involve listed companies, but also in all but the smallest mergers between non-listed companies. Investment banks provide advice to their client in this transaction.

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  - Typically we call a transaction a merger if two companies of comparable size are joined together with none of them taking an overly dominant role in the joint company afterwards, procedures and structures will show elements of both original companies. Fir example senior executive positions of the joint company are filled with those from both companies.
  - In contrast to that in an acquisition, the acquired company is integrated into the acquiring company and its structures and procedures are usually altere; senior executives might join in less prominent roles in the acquiring company, often only for a limited period of time. Investment banks will advise the acquiring company in the process.
  - They will also advise the acquired company.
  - Acquisitions can be friendly, where the acquired company agrees to being bought up by the acquirer, or it can be hostile, where the acquirer does not agree to the transaction. In hostile takeovers investment banks have the added role on advising overcoming any obstacles the traget might deploy to avoid the transaction, and for the target to advise on deploying such tactics to thwart the bidder.
- Deepending on the legal framework and the type of merger, the roles of the investment bank might differ and there will be more or less tasks to be completed and provide advice on.
- In all cases investment banks will value both companies involved and from that determine the minimum price a target will be requiring and the maximum price a bidder would be willing to pay and use this as a guide the advise on the proposed transaction price.
- Of importance is also the reaction of the capital market, mainly the stock market but potentially also the corporate bond market, and whether shareholder and the other management will accept any offers.
- Based on this analysis, investment banks will develop strategies of making an accepting offers, determining the price and other conditions.
- It is important to note that investment banks only provide advice, they do not purchase either of the companies involved or have any other stake in the outcome of the merger, apart from the effect it has on the fee they obtain.

→ Investment banks are not actively involved in the merger, they only provide advice, particularly on the price that is being offered or accepted.

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Investment banking contracts

- Investment banks provide advice for a fee, which is paid for by the company seeking it
- Contingent fee contracts are the most common contracts
- Clients pay the investment bank a fee in proportion to the value of the merger, provided the merger is completed
- In addition, often, clients have to pay the investment bank a fixed fee to cover their costs if the merger is abandoned

Investment banking contracts

- → Of special interest is the contract the company has with the investment bank, stipulating how the investment bank is paid for their advice. We take the ability of investment bank in conducting the valuation and providing any other advice as given and do not consider any impact contracts have on the incentives of the investment bank to conduct any analysis. Instead we focus on the advice, given that information has been obtain from the analysis of the investment bank.
- ▶ Investment banks do not provide their advice for free, they do not have a way to recover any costs from the transaction itself as they are not involved. The fee will be paid by the company seeking advice, which is commonly both companies involved in the merger. We thus typically have two investment banks being paid, one by each company.
- ▶ In mergers there is a specific contract type that dominates, which is often called a contingent fee contract.
- ▶ The investment bank is paid a fraction of the merger value, thus has an interest in a high merger value. However, this fee is only paid if the merger is completed. If the merger is abandoned, no fee is payable to the investment bank. This implies that a target might not seek a too high price as the bidder might not be willing to make such a high offer, causing the investment bank to not obtain a fee. Hence we might have a conflict of interest between the investment bank and its client about the best offer price.
- ▶ A common feature, in addition to the contingent fee contract, is that if a merger is not completed, the investment bank is eligible for a relatively small fee, covering its expenses. This fee is commonly small compared to the fee on completion of the merger. We will look at this break-up fee in the second model.
- → Investment banking contracts are well established and while specific parameters of these contracts are variable, the contingent fee contracts and break-up fees are dominating. This suggests that such contracts are optimal for either the investment bank, company, or both.

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The impact of contracts

- The advice will be such that it maximizes the profits of investment banks
- This advice might not always be in the best interest of their clients
- The resulting conflict of interest is affected by the way the fee is determined
- An investment bank offering a contract that has less conflicts of interest is at a competitive advantage
- The main advice investment banks give is whether to accept a merger offer, or which offer to make such that it is accepted

The impact of contracts

- → We will look initially only at the main feature of the investment banking contract, the way its fee is determined; the break-up fee wil be considered in the second model. How investment banks are paid, that is how their fees are determined, may well affect the advice they are giving as it provides specific incentives to them, but also their clients, who pay these fees.
- ▶ Investment banks will structure their advice such that it maximizes their own profits. Investment banks do not have the interest of their clients at heart, but they provide advice as a means to obtain the fee income.
- ▶ It will therefore be that the advice might not be in the best interest of their client. The advice given might differ from what would be the optimal advice for their client.
- ▶ Therefore the contract between the investment bank and their client will affect any conflicts of interest and we can use this contract, potentially, to minimise any conflicts of interest.
- ▶ With investment banks competing for clients, an investment bank offering a contract that reduces conflicts of interest might be more attractive to clients and the investment bank has a competitive advantage, resulting in this contract getting dominant in the market.
- ▶ A key part of the advice investment banks give is for a target whether to accept a merger offer that has been tabled and for a bidder what offer to make. We will consider only the price element of offers, but other aspects, for example board positions for senior managers, could be incorporated without changing the model.
- → The coming model will look at different contract types and how they affect the advice investment banks give about accepting and making offer, and compare this advice to that which is optimal for their clients.

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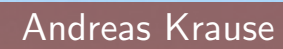

Chapter 6.2

Accepting merger offers

→ The model we are going to discuss is based on Chapter 6.2 of the book 'Theoretical Foundations of Investment Banking'. A more detailed description of the model, additional steps for its solution, and a more in-depth discussion of results can be found there.

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Discussion of the model results

- Contingent fee contracts are showing the least conflicts of interest and are the most common form observed
- Conflicts of interest are still present in these contracts and cannot be fully eliminated

? Can investment banks knowingly advice clients to accept or make offers that are not in their best interest?

! Concerns about their reputation would limit their incentives to advice clients incorrectly, but wrong advice might never be detected as information is incomplete

Discussion of the model results

→ Now that we have derived the main results of the model, as far as relevant for us, we will briefly discuss some implications as well as limitations of this model. This will allow us to interpret the model in its context of the initial problem and enables us to apply it appropriately in a realistic context.

- We have found that contingent fee contracts, where investment banks are paid a fraction of the merger value on completion of the merger, is optimal in the sense that it shows the smallest conflict of interest. This contract allowed for the advice to be distorted the least and align with clients' preferences more than other contract forms.
- However, even contingent fee contracts cannot align the interests of investment banks and their clients fully. There remains a conflict of interest and investment banks are urging clients too often to overpay as a bidder and not hold out for a better offer in the future.
- [?]We have identified a conflict of interest in our model and investment banks provide advice which they know is not ideal for their clients. In reality would investment banks systematically provide such biased advice¿
- [!] Providing wrong advice will damage the reputation of investment banks and this will be detrimental in the long run for their ability to attract clients; in this sense their ability to provide biased advise will be limited. However, it will be very difficult to detect such a bias in their advice; banks hold better information than their clients and the general public, the probability of a better offer will never be known, for example, nor will the conditions of a better offer that was never made. This informational symmetry will protect investment banks to a larger degree from reputational damage following biased advice.

→ We have seen that investment banks might advise their clients to accept or make less favourable offers than would be optimal. The contract form commonly found, the contingent fee contract, minimises these conflicts of interest, but cannot eliminate them. While reputational concerns might limit the investment banks' ability to provide such biased advice to their clients, the informational asymmetry between them and their clients and the general public makes detecting any bias difficult.

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Introducing an additional contractual arrangement

- Contingent fee contracts are commonly found in mergers & acquisitions, but they do not align incentives fully, leaving a substantial difference in the interest of waiting for a better offer or making a lower offer themselves
- There is another common feature in the contract, a fee that is payable if the merger is not completed
- We will now look at such a contractual arrangement, where a smaller fee is payable if the merger is abandoned and assess how this affects the incentives
- Given the informational advantage of investment banks, they have the potential to distort advice in their favour and at the expense of their clients, making it important that incentives are aligned to maximize the benefits to their clients

Introducing an additional contractual arrangement

- → Having established that the contingent fee contract is optimal in the sense of showing the least conflicts of interest, we will now look at improving this contract by adding an additional arrangement. We will be introducing a fee that is payable if the merger is not completed; this fee will only be payable if the merger discussion goes ahead after an initial assessment of the investment bank and is then subsequently abandoned.
- ▶
  - A contingent fee contract, as mentioned is a standard contract form in mergers and acquisitions and from our analysis we have seen that their ability to align the incentives of investment banks and their clients more than other contract from makes them attractive to companies.
  - However, there is still a substantial incentive for investment banks to suggest accepting a merger while the company would prefer to wait for a better offer. The investment bank might urge a target company to accept a low offer or make an offer that is too high. reducing the benefits to their client, but increasing their profits.
- ▶ Analysing the contracts clients have with investment banks in mergers and acquisitions, we find another common element that was so far not included in the contractual arrangement. This element is a fee that is payable if the merger is not completed. Such a fee is often referred to as a break-up fee.
- ▶ We will not look at a contract to allows for such a break-up fee to be introduced. We will analyse whether such a break-up fee is optimal for investment banks or clients and what its properties are. We will for example look at the amount of the break-up fee relative to the full fee.
- ▶
  - Investment banks have better information than their clients, which is the reason they are engaged to provide advice. This informational advantage can be used by investment banks to provide advice that is most profitable to the investment bank, but not their client.
  - Given this conflict of interest, which is still present in a contingent contract, we will look particularly at the incentives of investment banks and their clients, assessing how well they are aligned compared to a contingent contract, especially.
- → The model we will consider is designed to address the design of the contract between an investment bank and their client, and we will focus mainly on the break-up fee, having established the optimality of the contingent fee contract previously.

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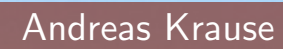

Chapter 6.3

Break-up fees

→ The model we are going to discuss is based on Chapter 6.3 of the book 'Theoretical Foundations of Investment Banking'. A more detailed description of the model, additional steps for its solution, and a more in-depth discussion of results can be found there.

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Discussion of the model results

- Break-up fees provide incentives to investment banks to give unbiased advice on the commencement of mergers
- Higher costs to clients of abandoning mergers reduces their incentive to commence with a merger and the higher fee income increases the incentives of investment banks to recommend continuing with a merger, allowing the incentives to be 5¿perfectly aligned

? This model suggested that mergers should be pursued if the likelihood of it being completed was sufficiently high, while the previously model suggested that an offer should be accepted if a better offer was unlikely to be received. How can these two approaches be reconciled?

! We can interpret the abandonment of the merger in the second model as accepting a low offer or making a high offer and focus on the case where the company holds out for better conditions, which are uncertain to be accepted

Discussion of the model results

→ Now that we have derived the main results of the model, as far as relevant for us, we will briefly discuss some implications as well as limitations of this model. This will allow us to interpret the model in its context of the initial problem and enables us to apply it appropriately in a realistic context.

- We have seen that only once we introduce a break-up fee into the contingent fee contract did we eliminate any conflicts of interest.
-
  - The break-up fee increases the costs of abandoning a merger to companies as they have to pay this fee; this makes them less keen to continue with a merger that might never be completed.
  - On the other hand, investment banks obtain additional revenue from the break-up fee and this makes them more inclined to recommend pursuing the merger as its later abandonment still provides them with some revenue.
  - These two effects are balanced exactly such that investment banks and their clients want to continue with a merger under the same conditions.
- [?] On the face of it the two models are quite different in the decision that investment banks and clients have to make. In the previous model a merger could always be completed by accepting the current low offer or making a high offer; it was only that waiting for a better offer or making a low offer might lead to the merger not being completed. In this last model, it was suggested that the merger offer was not relevant, a merger might or might not happen and the decision was whether to abandon the merger at this point or continue and hope the merger can be completed at set conditions. On the face of it this seems to be a rather different approach, but can they be made consistent?
- [!] We can re-interpret the last model as follows: If the merger is pursued further, an offer received will be rejected in the hope of obtaining a better offer, or the bidder makes alow offer which may or may not be accepted. If no better offer is forthcoming or the offer is rejected the merger is abandoned and the break-up fee is payable. If the merger is not pursued further after the initial assessment, the merger is completed quickly by accepting a low offer or making a high offer.

→ Break-up fees are an important element to ensure that the incentives of investment banks and their clients are aligned. Their prevalence in mergers and acquisitions suggests that clients value them and investment banks offer such contracts to remain competitive against other investment banks by offering a contract that is best for their clients.

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Summary of key results

- Advice in mergers & acquisitions is generally not in the best interest of their clients
- Using contingent fee contracts with a break-up fee aligns these interests
- A complex contract is used to ensure clients obtain unbiased advice, which is in their best interest

Summary of key results

→ We can now summarize the key results we have obtained about the importance of fee contracts in mergers and acquisitions.

- When providing advice to their clients on accepting a merger offer or the conditions to put into their own merger offer, investment banks and their clients can have different interests. The recommendation of the investment bank might not be optimal for their clients, but their lack of knowledge does not allow them to assess any bias.
- We have found that a contingent contract alone cannot fully align the interests of investment banks and their clients, a substantial difference remained. It was necessary to introduce a break-up fee to fully align the incentives of both contractual partners.
- We have established quite a complex contract: a fee that depends on the value of the merger, is only payable if the merger is completed, and in addition a fixed fee is payable if the merger is not completed. We thus have a contingent contract for successful mergers but a conditional contract for unsuccessful mergers.

→ Such complexity is not unusual in investment banking contracts, the complexity arises from conflicts of interests between investment banks and their clients; they show an attempt to minimize any distortions in the advice investment banks provide. By offering such complex contracts that allow for better advice, investment banks gain a competitive advantage over their other investment banks not offering such contracts. Competition will over time result in all investment banks using complex contracts and their use becomes commonplace.

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