Definition *Merger*

- A Merger is the combination of two companies of a similar size, where only one survives
- Usually the shareholders of the merged company become shareholders of the merging company

Definition *Consolidation*

- A consolidation is the combination of two companies of a similar size, where they form a new joint company
- The shareholders of both companies become shareholders of the new entity

Definition *Acquisition*

- An acquisition is the combination of two companies, with a significant difference in their sizes, where only one survives

- Usually the shareholders of the acquired company do not become shareholders of the acquiring company

Definition *Takeover*

- A takeover usually refers to an unfriendly acquisition or, less common, merger

Horizontal merger

- In a horizontal merger two competitors are merging
- Most common form of mergers
- Examples: Exxon and Mobil
Easyjet and Go
Glaxo and Wellcome

Vertical merger

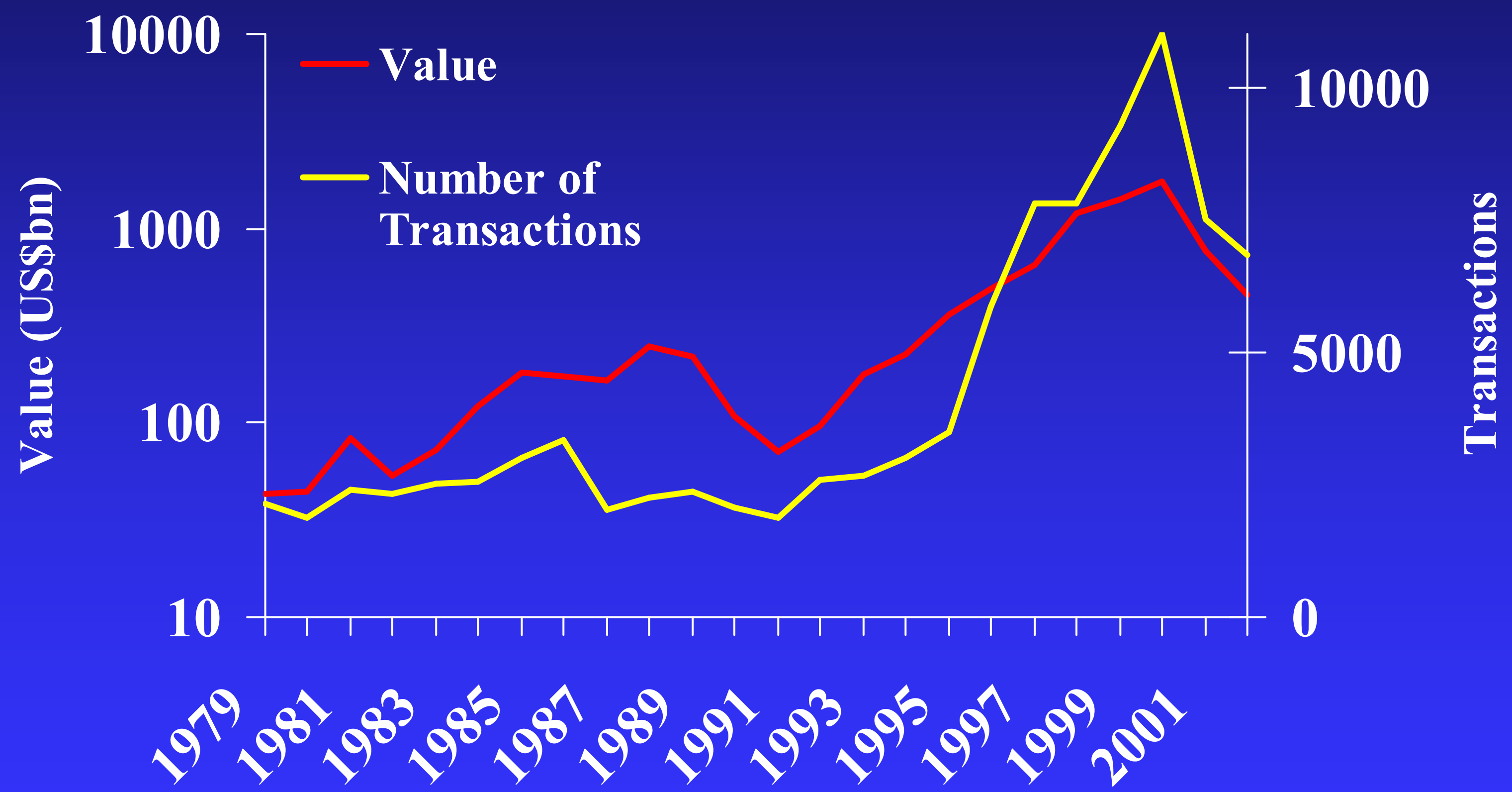
- In a vertical merger two companies in different phases of the production merge
- Examples: Warner and Time
  Medtronics and Merck

Conglomerate merger

- In a conglomerate merger two companies in different lines of business merge

- Examples: Phillip Morris and General Food
  General Electric
  Daimler

Merger activity in the US



Reasons for mergers

- Expansion
- Exploiting synergies
- Horizontal and vertical integration
- Diversification
- Hubris of managers
- Tax considerations
- …

Hubris of managers

- Managers have personal motives
- Building large companies increases reputation and power
- Larger companies pay higher remuneration

Does M&A pay – for the target ?

- Studies show that target shareholders receive abnormal returns of 20-30%
- About 90% show positive returns
- Result based on shareholder returns

Does M&A pay – for the buyer ?

- Short-term return to shareholders: No abnormal returns
- Equal balance between positive and negative returns
- Announcement returns

Does M&A pay– in the long run?

- Studies show that companies underperform following a merger
- Time horizon of 1-4 years
- Based only on stock market returns
- Results for profitability etc is mixed

Reasons for failures

- Diversification does not pay
- Synergies do not materialize as expected
- Market power increases less
- Regulation limits benefits
- Mergers often driven by hubris

Merger benefits - synergies

- Economies of scale
- Economies of scope
- Knowledge transfer
- Cross-selling
- Branding
- Increased future growth opportunities

Discounted cash flow

- $$Value = \sum_{t=0}^{\infty} \frac{CF_t}{(1+r)^t}$$

- The value of the company is the present value of all its future cash flows

Formula valuation III

- No growth: $$Value = \frac{CF_0}{r}$$
- Constant growth rate: $$Value = \frac{(1+g)CF_0}{r-g}$$
- More complex formulae are available

Comparable transactions

- Looks at similar transactions (industry, country, size of companies involved) and compares valuations
- Parameters usually used: price/earnings, price/sales and price/book value

Maximum bidding price

- This valuation gives you the maximum bidding price
- The actual bidding price might be less
- The current stock price serves as a lower boundary

Friendly vs. hostile takeover

- In a friendly takeover the management agrees to the deal
- Friendly takeover requires a lower premium
- Management provides more information to evaluate the company

Friendly takeover

- (Parts of the) management keep their positions
- Post-merger integration has not to overcome any resentments
- Hubris of managers can easily dominate the decision

Offer type

- Cash
- Shares
- Convertible bonds

Cash offer

- Cash is most popular with shareholders
- Easier to administer and set offer price
- Can be financed from existing resources or a new loan

Share offers

- No additional funds for the merger required
- Most common for “merger of equals” and large deals
- Risk of a dilution effect for shareholders of acquiring company
- Often a cash component included

Share performance

	Target	Bidder
Cash	30.2%	0.7%
Equity	15.1%	-1.1%
Cash or equity	27.6%	0.7%
Cash+equity	23.8%	0.3%
Convertible	11.7%	1.8%
Convertible+ equity	10.1%	-0.4%

Bid price

Determinants are:

- Pre-bid stock market price
- Merger benefits
- Existence of rival bidders
- Shareholder demands
- Premia in comparable transactions

Division of merger benefits

- Most benefits go to the target shareholders
- Acquirers often observe a negative stock market reaction

Hostile Takeovers

- Hostile takeovers are transactions that do not meet the approval of the target *management*
- To prevent hostile takeovers defence mechanism have been developed

Examples of hostile takeovers

- Vodafone takeover of Mannesmann
- Morrison takeover of Safeway (initially)

- In many cases political issues in international (hostile) takeovers

Shareholder interest hypothesis

- Preventing control changes increases shareholder wealth as managers focus more on daily business
- Bidding becomes more aggressive and increases the price offered

Management entrenchment hypothesis

- Any actions to prevent a takeover reduces wealth
- Aim is for the management to maintain control
- Interests of shareholders are not priority

Empirical results

- Weak evidence in favour of shareholder interest hypothesis
- If management holds either very small (< 5%) or large (>25%) stakes, entrenchment dominates

Preventing takeovers

- The best takeover defence is a high share price
- Observing market movements
- Public filings of acquirers

Types of takeover defences

- *Preventative measures*: reduce the likelihood of a takeover attempt
- *Active measures*: actions once a hostile bid has been made

Preventative measures

- Poison pills
- Corporate charter amendments
- Golden parachutes

Poison pills

- *Preferred stock plan*
  Issue dividend in preferred shares, convertible into common shares in case of takeover
- *Flip-over rights*
  Rights offer to shareholder to buy stock at low price in the acquiring company after a takeover
- *Flip-in Poison pills*
  Rights offer to shareholder to buy stock at low price in the target company if trigger event happens

Issuing poison pills

- Usually no shareholder approval required
- Rights go with shares until exercisable
- Rights can usually be redeemed for a small amount by the company
- Board can usually deactivate poison pills
- Poison pills can be issued even after a bid is received

Effect on shareholders

- Stock prices reduce slightly on adoption
- Companies with poison pills underperform

- Poison pills require larger takeover premium

Corporate charter amendments

- Staggered boards
- Supermajority rules
- Fair price provisions
- Dual capitalization

Staggered boards

- Terms of directors such that they may not be replaced all at once
- Prevents the complete control of the company by new owners
- Not very successful as a defence
- Share price is not significantly affected

Supermajority rules

- Corporate charter requires a higher approval of mergers, e.g. 2/3, 80%
- Can be waived if board approves merger
- Share prices reduced by 5% upon adoption if escape clause provided

Fair price provisions

- Acquirer has to pay minority shareholders at least a fair market price
- Fair price usually based on price-earning ratio
- Mostly included in takeover regulation
- Prevents lower offer in two-tier tender offers
- Share prices not significantly affected

Dual Capitalization

- Two classes of equity are generated
- Certain groups of voters have greater voting power, e.g. "Golden Shares" of governments after privatizations
- Small negative effect on share prices

Golden parachutes

- Agreement to pay special compensation to senior managers if they leave on change of control or the build-up of significant stakes
- Positive effect on share price and takeover premium

Preventative measures and stock performance

- If managers hold large fraction of shares, negative effect on share price
- Makes takeover less likely
- Shareholders cannot realize gains from takeover

Common preventative measures

- Poison pills
- Staggered board
- Golden parachutes

Active measures

- Greenmail
- Standstill agreement
- White knight
- White squire
- Capital structure adjustments
- Corporate restructuring
- Litigation
- Pac-Man defence

Greenmail

- Company repurchases shares from large shareholder at a premium
- Aims to prevent the takeover by a raider
- Evidence on the share price impact mixed

Standstill agreement

- Agreement with acquirer not to increase its holding further/beyond a threshold for a certain period of time
- Negative impact on share prices

White knight

- A company more acceptable to the management makes an offer
- Offer usually includes a higher price, an agreement on strategy and management, many times combined with break-up fees
- Can lead to a bidding war
- Mostly not beneficial for acquirer

White squire

- A company buys large block of shares, often convertible preferred shares
- In another version agreement to sell certain assets to this company in case of a takeover
- Prevents other bidders from gaining control

Capital structure adjustments

- Recapitalization
- Increasing debt
- Increasing equity
- Share repurchases

Recapitalization

- High dividend paid from increasing debt
- High leverage makes the company less attractive to bidder
- Managers may use their payments to buy shares cheaply

Increasing debt

- Assume a large amount of debt
- Borrowing capacity reduced and hence less attractive to bidder
- Increases the risk to shareholders
- Significant decline in share prices

Increasing equity

- More costly to acquire a majority of shares
- Dilutes shareholder equity and price reduces
- New shares issued to friendly investors, e.g. ESOP

Share repurchases

- Company buys back its own shares
- Uses cash or requires additional debt, making the target less attractive
- Reduces the number of shares available to hostile bidder

Corporate restructuring

- Used only as a measure of last resort
- Sale of assets the acquirer wants
- Make unattractive investments
- Usually very negative impact on share price

Litigation

- Very common strategy in more than 30% of cases
- Violation of antitrust regulation
- Incomplete disclosure of information to shareholders
- No net effect on share prices

Pac-Man defence

- The target tries to take over the bidder

- Not commonly used

Resistance to bidders

- Generally a resistance is viewed negatively by the market

- A bidder in itself is not good news

Strategies of the bidder

- Tender offers
- Proxy fights

Definition of tender offer

- Public shareholder publicly targeted
- Large percentage of shares bought
- Premium over current market price
- Firm conditions
- Offer contingent on minimum fraction of shares offered
- Offer valid for limited time

Usage of tender offers

- Most widely used strategy, but more expensive than negotiated deal
- Management is circumvented
- 80% of tender offers are successful

Effect of tender offers

- Positive share price effect for target only if taken over
- If target goes to rival the bidder's share price declines
- Bid premium higher with independent board

Definition proxy fight

- Attempt to take control, i.e. determine the management, through the corporate voting process
- Shareholders often do not vote in person, but use representatives: “proxies”
- “Bidder” tries to convince as many proxies as possible

Effects of proxy fights

- Usually positive effect of share price
- In most cases involved in mergers subsequently
- Success rate only 30%, but subsequent changes in management in another 30%

Legal aspects

- Any defences are subject to varied regulation
- Rules vary widely between countries
- Rules change continuously in response to events