Lecture 15 - Mergers and Acquisitions, LBOs, Divestitures, and Holding Companies

Mergers and Acquisitions

Merger: One firm absorbs the assets and liabilities of the other firm in a merger. The acquiring firm retains its identity. In many cases, control is shared between the two management teams. Transactions are generally conducted on friendly terms.
- In a consolidation, an entirely new firm is created.
- Mergers must comply with applicable laws. Usually, shareholders must approve the merger by a vote.

Mergers and Acquisitions

Acquisition: Traditionally, the term described a situation when a larger corporation purchases the assets or stock of a smaller corporation, while control remained exclusively with the larger corporation.
- Often a tender offer is made to the target firm (friendly) or directly to the shareholders (often a hostile takeover).
- Transactions that bypass the management are considered hostile, as the target firm’s managers are generally opposed to the deal.

Mergers and Acquisitions

In reality, there is always a bidder and a target. Almost all transactions could be classified as acquisitions. Some modern finance textbooks use the two terms interchangeably.
- Divestiture: a transaction in which a firm sells one of its subsidiaries or divisions to another firm.
- Spin-off: a transaction in which a firm either sells or issues all or part of its subsidiaries to its existing public investors, by issuing public equity.

Mergers and Acquisitions

Reasons given for divestitures and spin-offs:
- To undo non-profitable mergers (originally motivated by pure diversification)
- To “break up” a inefficiently run conglomerate
- In the case of spin-offs, to improve managerial efficiency in the subsidiary, by offering a directly observable stock price as an (admittedly imperfect) measure of managerial performance.
- Also, in the case of spin-offs, to give equity investors more flexibility in diversifying their investment portfolios.

Proxy Contest

A strategy that may accompany a hostile takeover.
- Occurs when the acquiring company attempts to convince shareholders to use their proxy votes to install new management that is open to the takeover.
- The technique allows the acquired to avoid paying a premium for the target. Also called proxy fight.
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Varieties of Takeovers

Mergers and Acquisitions

- Target: the corporation being purchased, when there is a clear buyer and seller.
- Bidder: The corporation that makes the purchase, when there is a clear buyer and seller. Also known as the acquiring firm.
- Friendly: The transaction takes place with the approval of each firm's management.
- Hostile merger: Target firm's management resists the merger.
  - Acquirer must go directly to the target firm's stockholders, try to get 51% to tender their shares.
  - Often, mergers that start out hostile end up as friendly, when offer price is raised.

Reasons for mergers & acquisitions:
- Strategic: The combined FCFs (Free Cash Flows) of the merged operation are greater than the sum of the individual cash flows.
- Financial: The cash flows and also the market value of the target are below their true value, due to perhaps inefficient management. Such firms are typically restructured after the acquisition.
- Diversification: “Don’t put all your eggs in one basket.”
  - Current finance literature seriously questions the merits of this reasoning.
  - Why does the management know better than the shareholders how to achieve diversification?
    - It is usually the case that shareholders can diversify much more easily than can a corporation.
    - Individuals can easily diversify by buying shares in mutual funds.

Synergy

- Suppose firm A is contemplating acquiring firm B.
- The synergy from the acquisition is
  \[ \text{Synergy} = V_{AB} - (V_A + V_B) \]
- The synergy of an acquisition can be determined from the usual discounted cash flow model:
  \[ \text{Synergy} = \sum_{t=1}^{\infty} \frac{\Delta CF_t}{(1 + r)^t} \]
  where
  \[ \Delta CF_t = \Delta Rev_t - \Delta Costs_t - \Delta Taxes_t - \Delta Capital Requirements_t \]

Source of Synergy from Acquisitions

- Revenue Enhancement
- Cost Reduction
- Including replacement of ineffective managers.
- Tax Gains
- Net Operating Losses
- Unused Debt Capacity
- Incremental new investment required in working capital and fixed assets

Some Valid Economic Justifications for Mergers

- Synergy: Value of the whole exceeds sum of the parts. Could arise from:
  - Operating economies
  - Financial economies
  - Differential management efficiency
  - Taxes (use accumulated losses)
  - Break-up value: Assets would be more valuable if broken up and sold to other companies.

Some Questionable Reasons for Mergers

- Diversification
- Purchase of assets at below replacement cost
- Acquire other firms to increase size, thus making it more difficult to be acquired
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Mergers and Acquisitions

- Discount FCF(M) at the cost of capital or WACC of the new corporation
- Obtain the present value of the new corporation \( V(M) \). If \( V(M) > V(T) + V(B) \) then proceed with the merger.
- How much should the bidder pay for the target?
  - At least \( V(T) \). In this case the bidder shareholders keep most benefits from merger.
  - At most \( V(M) - V(B) \). Here benefits accrue to target shareholders.

Mergers and Acquisitions LBOs, Divestitures, and Holding Companies

- In efficient markets, the stock market reaction on the day of the merger announcement represents the NPV of the transaction.
- Generally, bidder stock prices remain unchanged or even drop when an acquisition is announced. Historically bidding firm stock prices fall more often than increase.
- Target stock prices, however, increase by 20% to 40% on the announcement day.
- A good example is the market reaction to the Exxon/Mobil merger.

Mergers and Acquisitions

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Mergers and Acquisitions

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Example of Merger Valuation

- We will assume an acquisition of one mature firm by another: Firm A acquires Firm B. Recall that $PV_0 = \frac{CF_1}{(r-g)}$. Assume here that market equals intrinsic value.

- Firm A: expected $FCF_1 = $1000M, $wacc = 10\%$, $g = 6\%$, and 500M shares of common stock exist. We estimate its current (t=0) (stand-alone) value.
  \[ V_A = \frac{FCF_1}{wacc - g} = \frac{1000M}{0.10 - 0.06} = 25,000M \text{ ($25 billion)} \]  
  or 25,000M/500M = $50.00 per share.

- Firm B: expected $FCF_1 = $75M, $wacc = 12\%$, $g = 6\%$, and 100M shares of common stock exist. We estimate its current (t=0) (stand-alone) value.
  \[ V_B = \frac{FCF_1}{wacc - g} = \frac{75M}{0.12 - 0.06} = 1250M \text{ ($1.25 billion)} \]  
  or 1250M/100M = $12.50 per share.

Example of Merger Valuation, continued

- A combined Firm AB will generate a Free Cash Flow of $FCF_1 = $1130M next year (t=1). Calculate the incremental or $\Delta FCF_{AB}$.
  \[ \Delta FCF_{AB} = FCF_{AB} - [FCF_A + FCF_B] \]
  \[ \Delta FCF_{AB} = 1130M - [1000M + 75M] = 55M \]

- The combined Firm AB will produce $55M more FCF next year than the sum of what the stand-alone firms A and B can do on their own.

Example of Merger Valuation, continued

- What will be the Weighted Average Cost of Capital or WACC of the combined Firm AB.
- Let’s assume that A and B contribute proportionally (here, weighted by existing intrinsic values $V_A$ and $V_B$) to the new $WACC_{AB}$.
  \[ WACC_{AB} = [V_A/(V_A+V_B)]WACC_A + [V_B/(V_A+V_B)]WACC_B \]
  \[ WACC_{AB} = [25,000/(25,000+1250)](0.10) + [1250/(25,000+1250)](0.12) = 0.100952 \text{ or 10.0952\%} \]

Example of Merger Valuation, continued

- What is the proposed Firm AB worth? What price should Firm A pay? First, estimate the value of the combined Firm AB. Assume the FCF growth rate remains at $g = 6\%$ per year.
  \[ V_{AB} = \frac{FCF_{AB}}{wacc_{AB} - g} = \frac{1130M}{0.100992 - 0.06} = 27,593.28M \text{ ($27.593.28 billion)} \]
  \[ V_{synergy} = V_{AB} - (V_A + V_B) = 27593.28M - (25000M + 1250M) = 1343.04M \]

- The merged Firm AB is worth $27,593.28M, which is $1343.04M more than the firms are worth as stand-alone firms.
- Also the synergy or NPV of this merger is $1343.04M. This merger makes economic sense.
- However, at what price will Firm A be able to acquire Firm B?

Example of Merger Valuation, continued

- Scenario 1: What if Firm A pays a price that allocates all of the $V_{synergy}$ or merger NPV to the existing Firm A shareholders? The entire merger synergy or NPV will become impounded into the Firm A shares.
  - This involves paying $1250M or $12.50 per share for all the existing Firm B shares. Basically, Firm B shareholders are selling at the existing Firm B stock price of $12.50 per share!
  - New Firm A value = $(V_A + V_{synergy})/500M shares or $(25,000M + 1342.04M)/500M = $52.69 per share
  - Firm B shareholders are unlikely to approve such an offer.

Example of Merger Valuation, continued

- Scenario 2: What if Firm A pays a price that allocates all of the merger NPV or $V_{synergy}$ to the existing Firm B shareholders?
  - This involves paying $V_B + V_{synergy} = 1250M + 1343.04M = $2593.04M or $2593.04M/100M = $25.93 per share for all the existing Firm B shares.
  - Firm B shareholders are very likely to approve such an offer.
Example of Merger Valuation, continued

- Scenarios 1 and 2 represent what appear to be extremes of bidding on a target firm.
- Scenario 1, paying the existing $12.50 per share for Firm B, gives Firm A shareholders all of the merger NPV or $V_{synergy}$.
- Scenario 2, paying $25.93 per share (an almost 100% premium) for Firm B, gives Firm B shareholders all of the merger NPV or $V_{synergy}$. Firm A shareholders would receive no benefit.
- Ideally, the rational price would be one that allocates the merger NPV somewhat proportionally between the bidder and target firm shareholders.
- However, if history is any indicator, an price similar to scenario 2 (or even more) is the more likely outcome!

On Critical Perspectives

- Mergers and acquisitions have problematic human, social and societal consequences such as:
  - unemployment
  - stress, uncertainty, and insecurity about the future
  - cultural imperialism
  - decreasing possibilities to influence corporate decisions
  - reduction of competition
  - increasing power of specific corporations vis-à-vis suppliers and customers
  - decreasing power of nation states
  - institutionalization of the power position of experts such as consultants or investment bankers

On Critical Perspectives (cont.)

- Yet mergers and acquisitions are rarely analyzed from critical perspectives
- One should, however, be able to critically examine issues such as:
  - Corporate elitism
  - Instrumentalism
  - Colonialism
  - Fashion

Corporate elitism

- Mergers and acquisitions are often corporate elite driven projects:
  - Empire-building as a motive
  - Need to justify the decisions taken
- They have also a particular power position related to:
  - Control of relevant knowledge and information (e.g. plans and calculations)
  - Ability to invest in specific communication campaigns
- Experts such as consultants or investment bankers have also vested interests at play in these projects

Human Concerns and Instrumentalism

- Unfortunately, mergers and acquisitions often imply problematic consequences for the people involved, especially the workforce
- When focusing on ‘value creation’ or ‘synergy’, there is a great risk for instrumentalism:
  - Treating human subjects only as “organizational resources”
  - paying attention to human concerns only when trying to manage possible “organizational resistance” to changes.

Colonialism

- Mergers and acquisitions also involve colonialism; this is apparent when on party takes over another and imposes its culture and hegemony over the other
- This is manifested in:
  - power positions in the new post-merger organization
  - concrete decisions and choices concerning the processes and practices in the post-merger organization
  - resource deployment and transfer of knowledge
  - more fundamental value-based subjugation
- There is also a specific risk for neo-colonialism implying Anglo-American cultural dominance
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What Have We Learned?
- Understanding of the challenges that managers and organizational members involved in mergers and acquisitions are confronted with.
- Concepts and tools to make sense of and manage the complex social dynamics in post-merger and post-acquisition integration processes.
- Critical thinking around mergers and acquisitions.

Questions Concerning the Themes?
1. Explanations and motives for mergers and acquisitions.
2. Decision-making leading to mergers and acquisitions.
5. Cultural perspectives on post-merger integration.
6. Political perspectives on mergers and acquisitions.
7. Learning to manage mergers and acquisitions.
8. Critical perspectives on mergers and acquisitions.

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.

Divestitures
- The basic idea is to reduce the potential diversification discount associated with commingled operations and to increase corporate focus.
- Divestiture can take three forms:
  - Sale of assets: usually for cash.
  - Spinoff: parent company distributes shares of a subsidiary to shareholders. Shareholders wind up owning shares in two firms. Sometimes this is done with a public IPO.
  - Issuance if tracking stock: a class of common stock whose value is connected to the performance of a particular segment of the parent company.

The Corporate Charter
- The corporate charter establishes the conditions that allow a takeover.
- Target firms frequently amend corporate charters to make acquisitions more difficult.
- Examples:
  - Staggering the terms of the board of directors.
  - Requiring a supermajority shareholder approval of an acquisition.

Repurchase Standstill Agreements
- In a targeted repurchase the firm buys back its own stock from a potential acquirer, often at a premium.
- Critics of such payments label them greenmail.
- Standstill agreements are contracts where the bidding firm agrees to limit its holdings of another firm.
- These usually lead to cessation of takeover attempts.
- When the market decides that the target is out of play, the stock price falls.

Exclusionary Self-Tenders
- The opposite of a targeted repurchase.
- The target firm makes a tender offer for its own stock while excluding targeted shareholders.
Other Devices and the Jargon of Corporate Takeovers

- Golden parachutes are compensation to outgoing target firm management.
- Crown jewels are the major assets of the target. If the target firm management is desperate enough, they will sell off the crown jewels.
- Poison pills are measures of true desperation to make the firm unattractive to bidders. They reduce shareholder wealth.
- One example of a poison pill is giving the shareholders in a target firm the right to buy shares in the merged firm at a bargain price, contingent on another firm acquiring control.

Some Evidence on Acquisitions: The Long Run

- In the long run, the shareholders of acquiring firms experience below average returns.
- Cash-financed mergers are different than stock-financed mergers.
- Acquirers can be friendly or hostile. The shares of hostile cash acquirers outperformed those of friendly cash acquirers. One explanation is that unfriendly cash bidders are more likely to replace poor management.

What are Some Merger-related Activities of Investment Bankers?

- Identifying targets
- Arranging mergers
- Developing defensive tactics
- Establishing a fair value
- Financing mergers
- Arbitrage operations

Going Private and LBOs

- If the existing management buys the firm from the shareholders and takes it private.
- If it is financed with a lot of debt, it is a leveraged buyout (LBO).
- The extra debt provides a tax deduction for the new owners, while at the same time turning the previous managers into owners.
- This reduces the agency costs of equity

What is a Leveraged Buyout (LBO)?

- In an LBO, a small group of investors, normally including management, buys all of the publicly held stock, and hence takes the firm private.
- Purchase often financed with debt.
- After operating privately for a number of years, investors take the firm public to “cash out.”

What are the Advantages and Disadvantages of Going Private?

- Advantages:
  - Administrative cost savings
  - Increased managerial incentives
  - Increased managerial flexibility
  - Increased shareholder participation
- Disadvantages:
  - Limited access to equity capital
  - No way to capture return on investment
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What are the Major Types of Divestitures?
- Sale of an entire subsidiary to another firm.
- Spinning off a corporate subsidiary by giving the stock to existing shareholders.
- Carving out a corporate subsidiary by selling a minority interest.
- Outright liquidation of assets.

What Motivates Firms to Divest Assets?
- Subsidiary worth more to buyer than when operated by current owner.
- To settle antitrust issues.
- Subsidiary’s value increased if it operates independently.
- To change strategic direction.
- To shed money losers.
- To get needed cash when distressed.

What are Holding Companies?
- A holding company is a corporation formed for the sole purpose of owning the stocks of other companies.
- In a typical holding company, the subsidiary companies issue their own debt, but their equity is held by the holding company, which, in turn, sells stock to individual investors.

Advantages and Disadvantages of Holding Companies
- Advantages:
  - Control with fractional ownership.
  - Isolation of risks.
- Disadvantages:
  - Partial multiple taxation.
  - Ease of enforced dissolution.

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