Mergers and Acquisitions

Do Mergers build value? If yes, then how? How do you value Mergers? How do managers fight off “unfriendly” suitors?
Forms of Corporate Expansion

**Mergers:**

- “marriage in the romantic tradition”
- EITHER ‘A’ acquires ‘B’
  - ‘B’ ceases to exist after the merger
- OR ‘A’ + ‘B’ = ‘C’ (Consolidation)
  - both ‘A’ & ‘B’ cease to exist after the merger
Forms of Corporate Expansion--Continued

- **Horizontal Acquisitions:**
  - merger of “competitor” firms

- **Vertical Acquisitions:**
  - mergers between firms at different stages of production operations
    - Disney acquiring ABC

- **Conglomerate Acquisitions:**
  - unrelated businesses; Westinghouse/CBS
Acquisition of Stock

.DataGridViewCellStyle Tender Offers:

- offer to buy shares of another firm
- can bypass management/Board Of Directors
  - can be a “hostile takeover”
Tax Consequences of Acquisitions

**Taxable Transactions:**

- S/Hs of acquired firm get paid Cash or debt; e.g., ‘A’ acquires ‘B’
- B’s S/Hs have to pay immediate (calculate cost basis and pay taxes on any capital gains).
- A can write-up B’s assets to their fair mkt. value
  - recognize immediate taxable income
  - BUT depreciation expense goes up
    - future taxes ↓
Tax Consequences of Acquisitions-- Continued

**Tax-Free Transactions:**
- S/Hs of acquired firm get paid common stock or voting preferred
- B’s S/Hs have to pay **no immediate** taxes
- B’s assets can’t be written up
- Shareholders are deemed to have exchanged their old shares for new ones of equivalent value.
Accounting Treatment of Acquisitions

Pooling of Interests method:
- Eliminated on 6/30/01

Purchase method:
- “Goodwill” created
  = premium paid by the acquiring firm over and above the fair MV of acquired assets.
Accounting Treatment of Acquisitions-- Continued

Purchase method (Continued):

- Goodwill evaluated for possible “impairment”
  - If Not impaired, it remains on the B/S indefinitely
  - If impaired, amt. of impairment is “written down” from the goodwill a/c on the B/S and charged off against earnings.
  - lowers Earnings BUT not taxes
Synergy??  1+1=4???

- Whole > Sum of parts

- Operational Synergies

1. Economies of scale
   - average cost ↓ as volume ↑
     - beyond a certain volume there can be diseconomies of scale!!
   - mainly in production, but can also be in marketing/distribution......
   - more obvious in Horizontal mergers
Synergy-- Continued

1. Economies of Scale (continued):
   - Possibly in vertical Acquisitions as well
     - more efficient coordination at different levels

2. Economies of Scope
   - E.g., Ability to NOW launch a national advertising campaign

3. Complementary Strengths:
   - e.g., IBM & Lotus
Synergy-- Continued

Managerial Synergies

1. Differential Efficiency:
   efficiency (Mgmt_A) > efficiency (Mgmt_B)
   • Beneficial if ‘A’ acquires ‘B’ AND efficiency of ‘B’ is ↑ to the level of ‘A’
   • basis for horizontal mergers

2. Inefficient Management:
   • Management that is inept in an absolute sense
   • basis for conglomerate mergers
Gains from Tax Considerations

Tax-minimizing opportunities:
- a firm with accumulated tax losses & tax credits can shelter the positive earnings of another firm
- Increased debt capacity after merger
  - Probability of bankruptcy ↓
  - Merged firms might be able to have additional debt and ↑ firm value
Other “potential” sources of gains?

🔥 **Diversification of cash flows**

🌟 oft quoted reason for mergers
  • reduces variability of cash flows
    ◆ should be good for S/Hs as risk ↓ !!

🌟 S/Hs can diversify across firms LOT cheaper!!
Determining the Synergy from an Acquisition

Most acquisitions fail to create value for the acquirer.

The main reason why they do not, lies in failures to integrate 2 companies after a merger.

- Intellectual capital often walks out the door when acquisitions aren't handled carefully.
- Traditionally, acquisitions deliver value when they allow for scale economies or market power, better products and services in the market, or learning from the new firms.
NPV of a Merger

Payment in Cash: Market value of the joint firm ↑ by the amount of Expected Synergy

Payment in Stock: Value of the merger is a function of the exchange ratio:

- How many shares of ‘A’ are exchanged for ‘B’s shares?
Cash versus Common Stock

**Overvaluation**
- If the target firm shares are too pricey to buy with cash, then go with stock.

**Taxes**
- Cash acquisitions usually trigger taxes.
- Stock acquisitions are usually tax-free.

**Sharing Gains from the Merger**
- With a cash transaction, the target firm S/Hs are not entitled to any downstream synergies.
Takeover Defenses

How might the management of a “do-not-want-to-be-acquired” firm resist a takeover?

Defenses: make the firm:
- less attractive to raiders OR
- more difficult to take over
Takeover Defenses--Continued

- Antitakeover charter amendments
- Asset & ownership restructuring
  - both prior to and even after a hostile takeover bid is initiated
- Adoption of poison pill rights.......

Chhachhi/519/Ch. 29
Antitakeover Amendments

Shark Repellents:

- **Supermajority Amendment:**
  - require S/H approval by at least 2/3 vote (sometimes as high as 90%!!) for all Control change transactions

- **Staggered boards:**
  - only a fraction of the board is elected @ yr.
    - “hostile” acquirer has to wait a longer time to gain control of board
Evidence on Antitakeover Amendments

Do the shark repellents entrench the existing management?

S.P. ↓ as firms adopt these repellents
Targeted Share Repurchase & Standstill Agreements

**Greenmail:**
- Repurchase of a large block of stock from an individual S/H
  - Typically at a substantial premium
  - To end a hostile takeover threat

**Standstill Agreement:**
- S/H who is bought out agrees not to make further investment
Poison Pill Defense

 Securities that provide their holders special rights exercisable only after some time following a triggering event.
  - make it difficult /costly to acquire

 Do they help management negotiate a “better” price or “entrench” management?
  - S.P. drops at the adoption of poison pills!
Other Defensive Measures

- Scorched earth strategy:
  - Sell off “attractive” assets
  - Take on a lot of debt….
  - Might prevent a takeover but also adversely affect firm’s ability to compete in the marketplace.
Defensive Measures-- Continued

Golden Parachutes:
- “significant” compensation clauses that are triggered in case of loss of jobs when a change-of-control occurs

Leveraged Buy Outs (LBOs):
- Going private with a large amount of debt; V. popular (especially in 80s)
- provide tax shield and reduce agency problem
Do Acquisitions benefit S/Hs?

- Target’s S.P. typically goes up
- Acquirer’s S.P. either remains the same or goes down

H.W. 1, 2, 5, 10-12