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’ <u>acquires</u> ‘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

- 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 <u>can</u> 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

- 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……..

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 excercisable 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