Corporate Valuation, Restructuring and M&A's

Course Outline

Gazi Kabas
Tilburg University
Fall 2024

Housekeeping

- The tentative dates for the M&A part are Nov. 15, Nov. 18, Nov. 22, Nov. 27, Nov. 29, Dec. 2
  $\rightarrow$ I will let you know as soon as possible if there is a change
  $\rightarrow$ Prof. de Roon will teach on Nov 20.
- Material: Slides
- Guest lecture: Nov. 27.

Course Topics

1. Introduction to Mergers
    - Merger activity over time
    - Merger terminology
2. Motives for Mergers
    - Why do firms undertake mergers or acquisitions?
    - Why are the assets A and B worth more together than apart?
    - What predictions do the different theories have for the welfare of target and bidder shareholders?
3. Returns to Mergers
    - Does the method of payment matter for the returns to the merger?
    - Does it matter whether there are multiple bidders?
    - Does it matter what the motives of the merger are?
    - Case study: ASML

Course Topics

4. Takeover Defenses
    - What takeover defenses are used by firms?
    - How effective are they?
    - Does the implementation of them create or destroy shareholder value?
5. Going private and leverage buyouts
    - Why are leveraged buyouts undertaken?
    - Do they create value?
    - Where does the value creation come from?
6. Guest lecture
    - ABN Amro
    - Small businesses
    - There will be a question on the exam about this lecture!

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Introduction to Mergers

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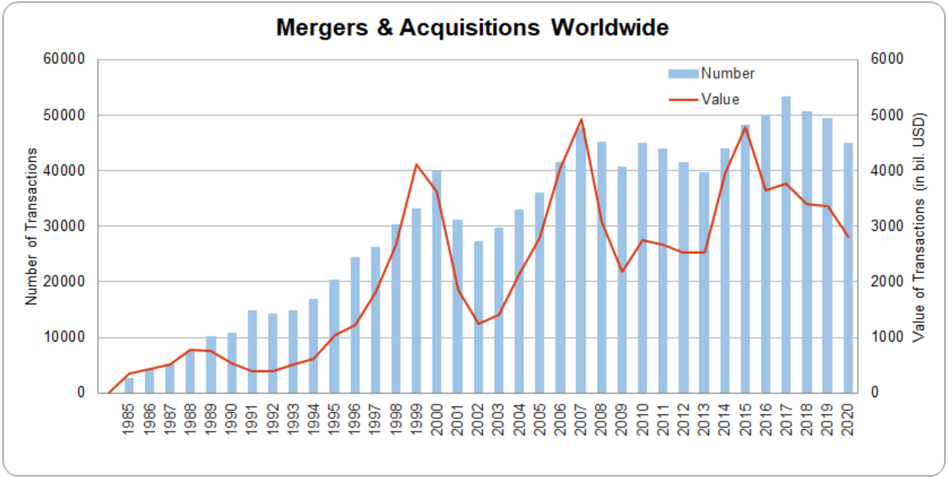
What is an M&A? Why Should We Care?

- **Merger:** Two (or more) companies come together to combine their resources and achieve a common goal. In practice, one company is often dominant. Mergers are often friendly (supported by incumbent management).
- **Acquisition:** One company acquires shares and control of another company.
- M&A is important because
  - An important event in firms' life cycles
  - Acts as a corporate governance tool
  - May generate value
  - Also, it is a big business

The Size of the Merger Business



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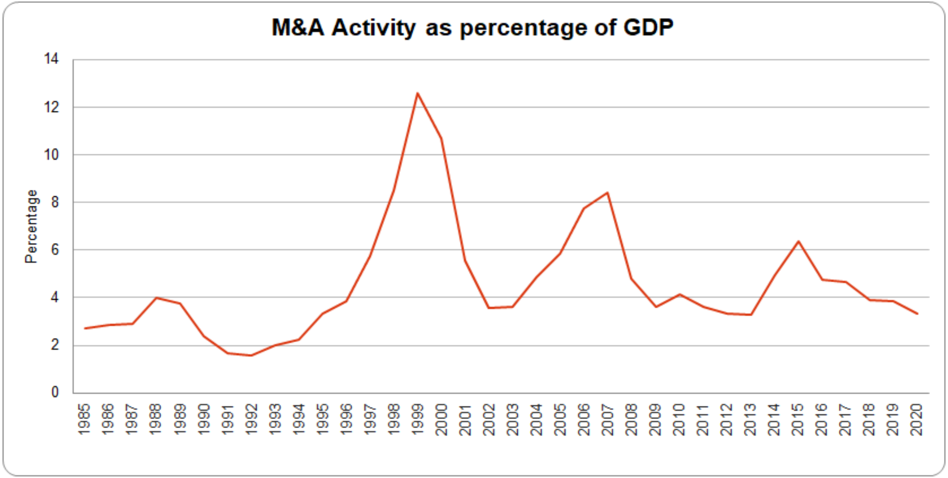

The Biggest Deals

Rank	Year	Acquirer	Target	Transaction value	Inflation adjusted
1	1999	Vodafone	Mannesmann	183.0	297.7
2	2000	AOL	Time Warner	182.0	286.4
3	2013	Verizon	Vodafone	130.0	151.2
4	2015	Dow Chemical	duPont	130.0	148.6
5	1999	Pfizer	Warner-Lambert	90.0	146.4
6	2007	Gaz de France	Suez	107.0	139.8
7	2004	Royal Dutch	Shell	95.0	136.3
8	1998	Exxon	Mobil	77.2	128.3
9	2019	United Technologies	Raytheon	121.0	128.2
10	2019	AB InBev	SABMiller	107.0	122.3

The Drivers of the Merger Business

1. Technological change
   - Computers, internet and information systems
2. Economies of scale, economies of scope, and the need to catch up technologically
   - AT&T acquired companies in the 1990s to catch up
   - Complementarities between internet, TV and other services
3. Globalization and freer trade
   - GATT, introduction of the EURO
4. Changes in industrial organization
   - Increased competition in airlines, financial services etc
5. Deregulation and regulation
6. Economic conditions, trends

Do Mergers and Acquisitions create value?

- Yes: M&A creates value by facilitating efficiency and moving resources to their optimal use
- No: Firms are already operating at their optimal capacity. M&A is just a way to redistribute the existing wealth across stakeholders

An opinion on the value of mergers

"Many managements apparently were overexposed in impressionable childhood years to the story in which the imprisoned handsome prince is released from a toad's body by a kiss from a beautiful princess. Consequently, they are certain their managerial kiss will do wonders for the profitability of Company T[arget]... Investors can always buy toads at the going price of toads. If investors instead bankroll princesses who wish to pay double for the right to kiss the toad, those kisses had better pack some real dynamite. We've observed many kisses, but few miracles. Nevertheless, many managerial princesses remain serenely confident about future potency of their kisses – even after corporate backyards are knee-deep in unresponsive toads...

We have tried occasionally to buy toads at bargain prices with results that have been chronicled in past reports. Clearly our kisses fell flat. We have done well with a couple of princes – but they were princes when purchased. At least our kisses didn't turn them into toads. And, finally we have occasionally been quite successful in purchasing fractional interests in easily identifiable princes at toadlike prices."

Warren Buffet

Merger Terminology

- **Tender offer:** A firm makes an offer directly to the shareholders to sell (tender) their shares at specified prices. Some tender offers may be hostile.
- **Conditional tender offer:** The tender offer is conditional on the bidder receiving a certain percentage of shares (normally 50%).
- **Restricted tender offer:** The bidder only accepts a certain percentage of outstanding shares, i.e., 50%. Often there is prorating all tendering shareholders sell a percentage of the tendered shares.
- **Two tiered tender offer:** A first tier is employed to get 50% of the shares – this offer is normally in cash. In the second tier a lower value can be offered since control has already been achieved. The second tier is often paid in securities such as debt rather than cash or equity of the bidder.

Merger Terminology

- **"Three-piece suitor" three steps:**
  1. An initial "toehold" is acquired by the bidder
     - A toehold is an initial stake in the target firm (normally 5%)
     - At 5% regulation 13(d) requires that the ownership is disclosed to the Securities and Exchange Commission (SEC).
  2. A tender offer is made to get control
  3. Minority shareholders are bought out in a squeeze-out
- **Minority squeeze out:** Majority of shareholders forces the sale of shares from the minority to the majority.
- **Equity carve out:** An offering of a full or partial interest of a subsidiary to the investment public.
- **Divestiture:** A sale of a particular set of assets of the firm to another firm.

Types of Mergers from an Economic Standpoint

- Three types of mergers, vertical, horizontal and conglomerate
  1. Horizontal: The two merging firms are competitors in the same industry
  2. Vertical: One of the merging firms uses the other firms' output as input
  3. Conglomerate: Merging firms are in unrelated businesses

Types of Mergers from an Economic Standpoint

Horizontal mergers
→ E.g. Exxon acquisition of Mobil in 1999

- One possible explanation is "economies of scale"
- Another potential explanation "monopoly power"
  → Cannot explain why mergers bunch in time
  → Not all small firms merge horizontally
- Industry roll up – a particular form of horizontal merger
  - One firm acquires a number of small firms in an industry - often motivated by the pursuit of "economies of scale"
  - Often the consolidator undertakes an IPO to get financing to purchase the small firms
  - Many consolidators that have taken the IPO route have filed for bankruptcy

Types of Mergers from an Economic Standpoint

Vertical mergers

- Oil industry (Exploration, production, refining, marketing)
  Pharmaceutical industry (R&D, drug production, marketing)
- Why vertical integration?
  - Improvement in production and inventory planning
  - Reduction of search, negotiation, payment collection and advertising costs if producer is located within the firm
  - Hold up problem may be avoided

The Hold-up Problem

- Hold-up problem, Klein, Crawford and Alchian (1978)
  - One firm must make an investment to transact with another. This investment is relation-specific; that is, its value is appreciably lower (perhaps zero) in any use other than supporting the transaction between the two parties.
  - Impossible to draw up a complete contract that covers all the possible issues that might arise in carrying out the transaction and could affect the sharing of the returns from the investment.
  - Example: Dies used to shape steel into the specific forms needed for sections of the body of a particular car model. These dies are expensive—they can cost tens of millions of dollars. Further, they are next-to-worthless if not used to make the part in question.
    Suppose the dies are paid for and owned by an outside part supplier. Then the supplier will be vulnerable to hold-up. Because any original contract is incomplete, situations are very likely to arise after the investment has been made that require the two parties to negotiate over the nature and terms of their future interactions. Such ex post bargaining may allow the automobile manufacturer to take advantage of the fact that the dies cannot be used elsewhere to force a price reduction that grabs some of the returns to the investment that the supplier had hoped to enjoy.

The Hold-up Problem

- Hold-up problem, Klein, Crawford and Alchian (1978)
    - Outcome: The supplier may then be unwilling to invest in the specific assets, or it may expend resources to protect itself against the threat of holdup. In either case, inefficiency results: either the market does not bring about optimal investment, or resources are expended on socially wasteful defensive measures.
      Having the auto company own the dies solves the problem.
- Vertical integration solves the hold-up problem.

Types of Mergers from an Economic Standpoint

Conglomerate Mergers (Firms involved in unrelated business)
$\rightarrow$ E.g. merger of Mobil Oil and Montgomery Ward

- Reduce risk through diversification
  - Combination of businesses whose returns are not highly correlated would reduce the overall variance of the returns
- Better financial planning and control
  - In practice, conglomerates have "more professional" financial planning
  - Improves resource allocation
- Can be easier to change the management
  - Less dependent on business-specific knowledge

Legal Aspects of Mergers

- Statutory Provisions of mergers (depends on the country(ies) that firms are chartered)
  - Percentage of vote required to approve M&A
  - Who is entitled to vote
  - The rights of the voters that object to the transaction
- Ex: Statutes in Delaware (typical)
  - Board of directors have to approve the transaction first
  - Then submitted for ratification to the shareholders of respective corporation

    → Prior to the 1960s most states required 2/3 majority

    → 1967 Delaware required majority vote, other states include California, Michigan and New Jersey

    → New York still requires 2/3 majority

    → Most mergers are approved...