Corporate Valuation, Restructuring and M&A's

Takeover Defenses

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Hostile takeover

- **Hostile takeover**: An unsolicited offer made by a potential acquirer that is resisted by the target firm's management. Hostile transactions normally are disclosed in the press.
  1. The target company doesn't ask for it
  2. The target company doesn't want it
  3. Disclosed in the press
- **How?**
  1. Tender offer: Public announcement with a premium over the current market price. Target management usually tries to "fight" the offer – For example, puts out statements that the offer is detrimental to the company
  2. Proxy Contest: Obtain the voting rights from the shareholders to get voting power. Bidders try to convince the majority of the target shareholders to vote for them.

Why can a firm become a takeover target?

- **Low current stock price**

  → Long-range investment plans with payoffs that are not reflected in its current stock price

  → A low stock price in relation to the replacement costs (low q-ratio)

  → Balance sheet (excess cash, strong securities portfolio, unused debt capacity), good cash flow

- **Divestable business units**

  → Subsidiaries or properties that could be sold off without significantly impairing cash flow

- **Low managerial entrenchment**

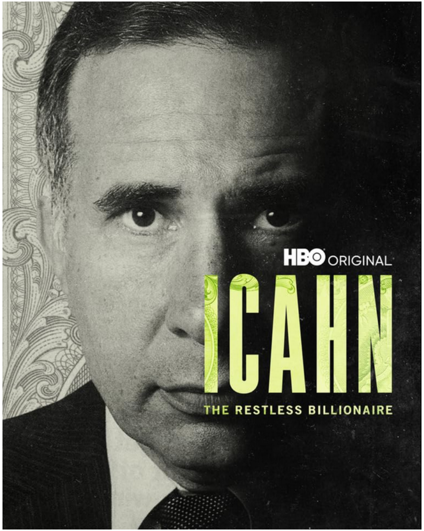
  → Relatively small stock holdings under the control of incumbent management

Microsoft and Yahoo!

- Feb. 1, 2008: Microsoft announces plans to acquire Yahoo! in a hostile transaction
  → Initial friendly talks didn't work.
  → Offer: 31USD per share (62% premium!)
- Feb. 11, 2008: Yahoo! officially rejects Microsoft's offer, citing the offer would "substantially undervalue" the company
  → In the subsequent two months, lawsuits started, with shareholders suing Yahoo! for not accepting/supporting the offer
- May, 2008: Yahoo! finally threatened to fight the deal, which led to Microsoft withdrawing its offer

Microsoft and Yahoo!

- Then Carl Icahn steps in...



Microsoft and Yahoo!

- Carl Icahn initiated a proxy contest
  → The goal: To replace the board of Yahoo! because they rejected Microsoft's offer
  → Icahn nominated 10 people of his choice to go on the board of directors and ask for shareholders' proxies to elect them
  → Open letter: "I have therefore taken the following actions: (1) during the last 10 days, I have purchased approximately 59 million shares and share-equivalents of Yahoo; (2) I have formed a 10-person slate which will stand for election against the current board; and (3) I have sought antitrust clearance from the Federal Trade Commission to acquire up to approximately \$2.5 billion worth of Yahoo stock."
- Yahoo! also fought him on that and settled by offering him and two associates seats on their board

Takeover Defenses

- Why would a firm want to engage in defensive tactics?
  $\rightarrow$ Resist to get a better price
  $\rightarrow$ Target's management thinks that the company will perform better on its own
  $\rightarrow$ Target's management doesn't want to lose its authority
- Defensive tactics can take two general forms
  $\rightarrow$ Preventative anti-takeover measures: Poison pills/poison puts, amendments, state laws, golden parachutes
  $\rightarrow$ Active anti-takeover measures: Financial measures, corporate restructuring, greenmail, Pac Man defense, white knight/white squire

Poison Pills

- Poison pill: Creation of securities carrying special rights exercisable by a trigger event
  $\rightarrow$ Triggering event can be an accumulation of a specified percentage of target shares, or an announcement of a tender offer
- These special rights make it more costly to acquire control of the target firm
  $\rightarrow$ For instance, existing shareholders of the target company may receive heavily discounted shares of the merged firm if a trigger event happens
- Also called "shareholder rights" plans
- More than 33% of large US firms have poison pills of various sorts
- The most common version is called Flip-in
  $\rightarrow$ Existing shareholders receive heavily discounted additional shares if a trigger event happens
  $\rightarrow$ Dilutes the bidders share
- Generally not allowed in Europe, except Netherlands

Poison Pills

- Elon Musk vs Twitter
  → Musk made an offer with 25% premium on April 14th.
  → Twitter board took a poison pill the next day.
  → Trigger: If an investor reaches a 15% stake
  → This poison pill allows each current shareholder to acquire the stocks with half of the market price, except Musk
  → The poison pill dilutes the shares and makes the acquisition more expensive for Musk

Poison Put

- Poison Put: Issuance of a bond with the option of obtaining repayment in the event that a hostile takeover occurs before the bond's maturity date
  $\rightarrow$ Written as a covenant on the bond
- Places a large cash demand on the new owner
- Does not affect shares or voting rights

Golden Parachute

- Golden Parachute: Compensation package for executives (or all employees) if they lose their jobs due to a change-of-control clause
  $\rightarrow$ Usually, a lump-sum payment over a specified period
- Rationale
  $\rightarrow$ Implicit contracts for managerial compensation: managers' real contribution can only be estimated better as time passes, requiring deferred compensation.
  $\rightarrow$ Firm-specific investment by managers. If managers lose their jobs after a control change, they would not make firm-specific investments
  $\rightarrow$ Golden parachutes may encourage managers to accept changes, which can benefit the shareholders. This reduces the conflict of interest between managers and shareholders
- Yahoo! vs Microsoft
  $\rightarrow$ Yahoo! enacted a severance benefits plan for all the workforce after Microsoft's hostile bid
  $\rightarrow$ Given Microsoft's plan to cut 1,000 jobs, the plan would cost the acquirer between 1 and 3 billion USD.

Takeover Regulation

- Lobbying or reincorporation in a state with more accommodating anti-takeover laws
  $\rightarrow$ Several states (Delaware included): a 3-year moratorium on takeover unless
  - Bidder obtains approval of the board
  - Bidder obtains a 2/3 majority of other shareholders
- A takeover regulation can replace other takeover defences
  $\rightarrow$ After Delaware's stricter takeover protection, managers reduce the riskiness of their firms (Low, 2009)

Financial Restructuring

- Use debt to repurchase equity $\rightarrow$ Higher debt reduces cash inflow $\rightarrow$ Increases management's percentage holdings
- Reduce available cash
  $\rightarrow$ Increase dividends
  $\rightarrow$ Higher investment
- Restructure loan covenants
  $\rightarrow$ In such a way that takeover forces acceleration of debt repayment

Corporate Restructuring

There are three main forms of restructuring and divestiture

1. Sell-offs and divestitures

   → Sell off the divisions that the raider wants (selling off the crown jewels)

   → Could be seen as extreme, i.e., "burning company to the ground"

   → Whittaker vs. Brunswick: Whittaker offers 618 million for Brunswick, mostly due to Sherwood Medical. Yet, Brunswick sold Sherwood Medical for 620 million to American Home Products

   → Theoretically, divestitures can generate value by improving managerial incentives or enabling shareholders to monitor managerial performance better.

2. Asset acquisition

   → To create antitrust problems for the bidder

3. Defensive MBO (LBO)

   → The incumbent management raises the money to launch a competing takeover bid on the target

Greenmail

- The firm buys the bidders' stock (but no-one else's) at a large premium over the public market price → "Here is some money. Now go away!"
- Greenmail = greenback + blackmail
  → Corporate "raiders" blackmail a company into handing over money (greenback) by using the threat of a takeover
- Greenmail causes damage to shareholders
  → Raiders use their existing power to loot the corporate treasury
  → Current managers do not want to lose their power and use the corporate treasury
- Greenmail may be helpful for management changes
  → Raiders may point out the problems with corporate personnel or corporate policy
  → 40% of targets experience a control change within 3 years
- Standstill agreement: voluntary contract in which the raider agrees not to make further investments in the target company during a specified period of time
- Greenmail generally results in negative abnormal return (2-3%)
  → Not robust

Pac Man Defense

- Target makes a counter-offer to buy the raider
  $\rightarrow$ Like the Pac Man game
- Likely to be effective if the target is significantly larger than the raider
- Implies that the target finds combining the two firms desirable
- Not credible and too costly, therefore rarely used
- Volkswagen and Porsche: Between 2005 and 2008, Porsche increased its stake in VW, using high amount of debt. VW requires 80% ownership for control, while Lower Saxony held a voting share of 20.2%. After the crisis, Porsche's lenders were reluctant to support this deal. At the end, VW took over Porsche in 2009.

White Knight / White Squire

- White Knight: Target finds another company to do a friendly takeover
  $\rightarrow$ New bidder might promise not to break up the target, or not to engage in massive employee dismissals
- White Squires: Target finds a company to buy a big block of its stock
  $\rightarrow$ Third party does not acquire control of the target (hence squire)
  $\rightarrow$ Often a standstill agreement that limits squire to buy more target's share
  $\rightarrow$ White squire usually gets a seat on target's board, generous dividends, discount on target shares

Anti-Takeover Amendments

- These amendments impose new conditions on the transfer of control of the firm
  $\rightarrow$ Known as shark repellents
- Supermajority amendment: A large share of votes (usually 67%) is needed to change the top management
- Staggered or classified boards: Delay effective transfer of control in a takeover
  $\rightarrow$ Shareholders elect 1/3 of the board every year (three years to fully control the board and 2 years to get a majority)
  $\rightarrow$ After Anheuser-Busch switched to annual appointment from a staggered board, it was acquired by InBev. Now, AB InBev controls almost 30% of the world's beer market.
- Authorization of preferred stock: A new class of securities with special voting rights.
  $\rightarrow$ May be issued to friendly parties

Conclusion

- Takeover defenses have become an important task for management
- These defenses can improve firm value by creating an auction for the target, or preventing coercive tender offers
- At the same time, they can increase cost of takeovers, which reduces the efficiency in corporate control
- These tools should maximize the shareholders' interests
  $\rightarrow$ If an offer is rejected, there have to be sound reasons
  $\rightarrow$ Approve a transaction only if it is fair to shareholders
  $\rightarrow$ Explore independent competitive bids and obtain best offer