Merger & Acquisition Basics

MBA 702

Module 6, part 1

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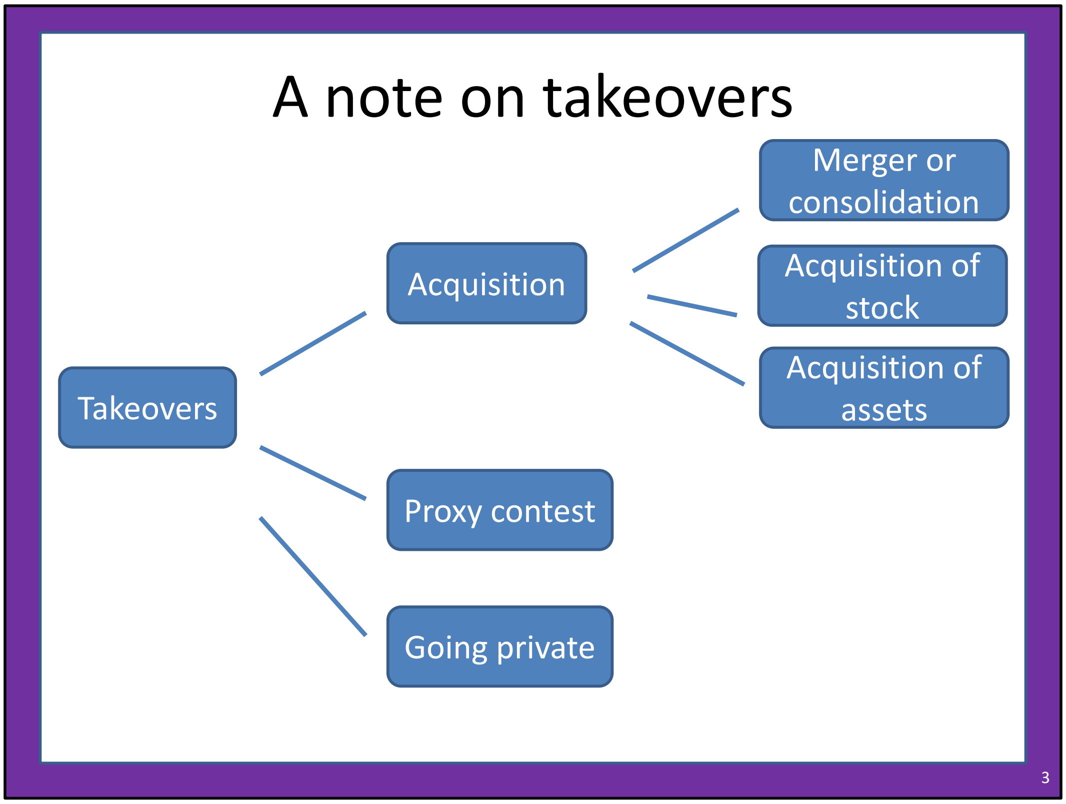
Our first topic in this course is an introduction to mergers & acquisitions. We are by no means covering the topic in depth. We will cover the highlights, including some of the key valuation calculations underlying M&A activity.

Note that there is a practical application (worth 30 points) on M&A due on Sunday of Week 6.

Introduction

- The acquisition of one firm by another is an investment made under uncertainty, and the basic principles of valuation apply.
- Special issues to that come up in this area of finance:
  - Benefits of the acquisition can depend on strategic fits
  - Accounting, tax and legal effects need to be considered
  - Conflicts of interest between managers and company shareholders may be a factor to be considered
  - Not all acquisitions are "friendly", sometimes the takeover is unwelcome from the bidder's viewpoint (a hostile takeover)



- Takeover is a general an imprecise term referring to the transfer of control of a firm from one group of shareholders to another.
    - A takeover thus occurs whenever one group takes control from another.
- Takeovers can be by **acquisition**, which can be by merger or consolidation, acquisition of stock or acquisition of assets. In mergers and tender offers, the bidder buys the voting common stock of the target firm. This is the area we will focus on in this module.
- Takeovers can also occur with proxy contests.
    - **Proxy contests** are an attempt to gain control of a firm by soliciting a sufficient number of stockholder votes to replace existing management. A proxy is the right to cast someone else's votes. In a proxy contest, proxies are solicited by an unhappy group of shareholders form the rest of the shareholders.
- In **going-private** transactions, all of the equity shares of a public firm are purchased by a small group of investors. Usually the group includes members of current management and some outside investors.
    - These transactions are generically called leveraged buyouts (LBOs) because a large percentage of the money needed to buy the stock is borrowed.
    - These transactions are also called management buyouts (MBOs) when existing management is heavily involved.

Legal forms of acquisition

- Basic legal procedures one firm can use to acquire another firm:
  – Merger or consolidation
  – Acquisition of stock
  – Acquisition of assets
- Commonly, the term “merger” is used, irrespective of the actual legal procedure
- Acquiring firm is referred to as the **bidder**
- Firm that is sought (and perhaps acquired) is the **target**
- Either cash or securities are offered by the bidder as consideration in the acquisition

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From a legal standpoint, mergers or consolidations and acquisition by stock or acquisitions by assets are different, but the press frequently makes no distinction between the forms. Commonly, simply the term “merger” is used in the press.

Acquiring firm or “bidder” this is the company that offers to pay cash or securities to obtain the stock or assets of another company.

The firm that is sought by the bidder is the “target”

As payment, or consideration, in the acquisition either cash or securities may be used. For example, maybe the bidding firm offers to pay cash or offers shares of the acquiring firm for each x shares of the bidder’s stock.

Merger or consolidation

- Merger is the complete absorption of one company by another, wherein the acquiring firm retains its identity and the acquired firm ceases to exist as a separate entity.
- Consolidation is a merger in which an entirely new firm is created and both the acquired firm and the acquiring firm cease to exist

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Merger – the complete absorption of one company by another (assets and liabilities). The bidder remains and the target ceases to exist.

Primary advantage is that a merger is legally simple and does not cost as much as other forms of acquisition.

> Firms agree to combine their entire operations, so there is no need to transfer title to individual assets of the acquired firm to the acquiring firm.

Primary disadvantage is that a merger must be approved by a vote of the stockholders of each firm.

> Typically, two-thirds (or more) of the share votes are required for approval.

Consolidation – a new firm is created. Joined firms cease their previous existence.

Acquisition of stock

- A bidding firm may choose to acquire another firm by purchasing the target's voting stock
  - Management of bidding firm makes **private** offer to management of target
- Tender offer – a **public** offer to buy shares of another firm
  - Avoids target firm management, offer made to target shareholders
  - Not all shareholders may accept the offer and the target is not completely absorbed

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The bidding firm may buy the target's voting stock (outstanding shares) with an exchange of cash, shares of stock (in the acquiring firm), or with other securities

This process commonly starts as a private offer from management of one firm to that of another

Tender offer is a public offer by one firm to directly buy the shares of another firm.

- Communicated to the target firm's shareholders by public announcements such as those made in newspaper advertisements.
- Tender offer is frequently contingent on the bidder's obtaining some percentage of the total voting shares. In other words, the offer to buy the shares only happens if at least some percentage of the total shares can be acquired. The bidding firm wants control of the target.
- Shareholders who choose to accept the offer tender their shares by exchanging them for cash or securities (or both), depending on the offer.

- If the acquisition is by stock
  - no shareholder meeting is required, and no vote is necessary. If the shareholders of the target firm don't like the offer, they are not required to accept it and need not tender their shares.
  - Bidding firm deals directly with target firm shareholders by using a tender offer

- This acquisition is sometimes unfriendly – it may be used to circumvent target firm management, which is usually actively resisting the acquisition.
- Frequently, a significant minority of shareholders will hold out in a tender offer; target firm cannot be completely absorbed when this happens, and this may delay realization of merger benefits or be costly in some other way.
- Complete absorption of one firm by another requires a merger.

Acquisition of assets

- Bidder can buy most or all of the target's assets
  - Target firm may not cease to exist, it is simply selling off assets
  - The "shell" of the firm will exist unless stockholders choose to dissolve it
- A formal vote of the shareholders of the selling firm is required

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- If the bidder buys the assets (or at least most of them), the target firm is now basically a shell, with few, if any, assets. At this point, the shareholders may well choose to dissolve the firm.
- A formal vote of the shareholders is required in order for the assets to be sold, as it pretty much guts the company.
  - Advantage to this approach is that there is no problem with minority shareholders holding out.
  - Disadvantage is that the acquisition of assets may involve transferring titles to individual assets, and the legal process of transferring assets can be costly.

Taxes and acquisitions

- If one firm buys another, transaction may be taxable or tax-free.
  - In a taxable acquisition, shareholders of target firm are considered to have sold their shares, and they will have capital gains or losses that will be taxed.
  - In a tax-free acquisition, acquisition is considered an exchange instead of a sale, so no capital gain or loss occurs at the time of transaction.

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- General requirements for tax-free status are that acquisition be for a business purpose, not to avoid taxes, and there is a continuity of equity interest.
  - Specific requirements for a tax-free acquisition depend on legal form of acquisition; but, in general, if the buying firm offers the selling firm cash for its equity, it will be a taxable acquisition.
  - If shares of stock are offered, the transaction will generally be a tax-free acquisition.

Gains from acquisitions - synergy

- Synergy is the positive incremental net gain associated with the combination of two firms through a merger or acquisition
  - Va is the market value of the acquirer
  - Vb is the market value of the target firm
  - Vab is the total value of the combined firm
- For a merger to make sense, the combined firm must have greater value than the value of the two firms
- Difference between the value of the combined firm and the sum of the values of the firms as separate entities is the incremental net gain from the acquisition, ΔV
  - ΔV = Vab – (Va + Vb)
  - If ΔV is positive, the acquisition is said to generate synergy

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Suppose Firm A is contemplating acquiring Firm B.

Successful merger requires value of the whole (that is combined firm) exceed the sum of the parts (that is values of separate firms).

Va is the market value of the acquirer

Vb is the market value of the target firm

Vab is the combine value of the merged firm

If Vab > Va + Vb, where did the difference come from? That is the incremental value gained by the two firms combining.

ΔV = Vab – (Va + Vb)

If ΔV is positive, the acquisition is said to generate synergy

Synergy

- If Firm A buys Firm B, it gets a company worth Vb plus the incremental gain, ΔV, so the value of Firm B to Firm A (Vb^*) is:

Value of Firm B to Firm A = $V_B^* = \Delta V + V_B$

- V_B^* can be determined in two steps:
  1. Estimating V_B
  2. Estimating ΔV
     - ΔV is based on incremental cash flow ΔCF, or the cash flows for the combined firm less what the two firms could generate separately.
     - ΔCF = ΔEBIT + ΔDepreciation + ΔTax − ΔCapital requirements = ΔRevenue − ΔCost − ΔTax − ΔCapital requirements.
  - Merger will make sense only if one or more of these cash flow components are beneficially affected by the merger.

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- If B is a public company, its market value as an independent firm under existing management (VB) can be observed directly, but if Firm B is not publicly owned, its value will have to be estimated based on similar companies that are publicly owned.
- Firm A has offered $4mm in cash for firm B
- If firm B is publicly traded, then calculating Vb is straightforward:
    - Let's say that B has 1mm shares of stock outstanding at $3.75 per share, Vb = $3.75mm
- If firm B is privately held, then things get a little more complicated and the market value of the firm might be estimated as the present value of their future cash flows **or based on similar companies that are publicly owned.**
- Those future cash flows need to be estimated, along with the "appropriate" discount rate

- As to estimating ΔV, it could be that because of the acquisition, the combined new firm are anticipated to be higher that the sum of revenues of the two firms alone. In which case, we again use the PV of the increase, discounted at the appropriate rate to estimate ΔV.
- These estimations would be complex and vital. Note that in the problems you will see this week, some very simplified assumptions will be used. The values for ΔV will be very straight-forward.

Sources of ΔV

- The incremental value of the acquisition comes down to increased cash flows
- **For the merger to make sense, at least one of the cash flow components must be beneficial**
- Incremental increase in cash flows ΔCF can be either from revenues or expenses
  - Change in revenues
  - Change in operating profit or EBIT
  - Change in depreciation
  - Tax changes
  - Changes in capital requirements

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- The incremental increase in cash flows (CF of combined firm minus what the two firms would have had on their own) would be based on:
  - Change in revenues
  - Change in operating profit or EBIT
  - Change in depreciation
  - Tax changes
  - Changes in capital requirements

- For the merger to make sense, at least one of the cash flow components must be beneficial (and outweigh any negative cash flow impacts)
  - Revenues may be greater as a combined firm
    - This could be from marketing gains
    - Strategic benefits - opportunities to take advantage of the competitive environment if certain things occur or, more generally, to enhance management flexibility with regard to the company's future operations
    - Increase in market power – maybe profit can be enhanced through higher prices and reduced competition for customers
      - Mergers that substantially reduce competition may be challenged

by U.S. Department of Justice or Federal Trade Commission on antitrust grounds.

- Cost reductions, which would directly increase the EBIT (operating profit)
    - Economies of scale, where average cost per unit is reduced – overhead can be reduced if central facilities (corporate management) and top management and/or computer services can be streamlined
    - Economies of vertical integration have a main purpose of making it easier to coordinate closely related operating activities. For example, most forest product firms that cut timber also own sawmills and hauling equipment.
    - Complementary resources - For example, a ski equipment store may merge with a tennis equipment store to produce more even sales over both the winter and summer seasons, thereby better using store capacity.

- Tax reductions maybe
    - Use of tax losses.
    - Use of unused debt capacity.
    - Use of surplus funds.
    - Ability to write up the value of depreciable assets.
- Lower capital needs
    - All firms must invest in working capital and fixed assets to sustain an efficient level of operating activity.
        - A merger may reduce the combined investments needed by the two firms.
    - Acquiring firms may see ways of more effectively managing existing assets.
        - Can occur with a reduction in working capital resulting from more efficient handling of cash, accounts receivable, and inventory.
    - Acquiring firm may also sell off certain assets that are not needed in the combined firm.

Avoiding mistakes

- Evaluating the benefit of a potential acquisition is more difficult than a standard capital budgeting analysis.
- Here are some general rules that should be remembered:
  - Do not ignore market values
  - Estimate only incremental cash flows
  - Use the correct discount rate
  - Be aware of transaction costs
- Some firms could increase in value with a change in management; mergers are a means of replacing management in such cases.

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- Do not ignore market values: There is no point to, and little gain from, estimating the value of a publicly traded firm when that value can be directly observed.
- Estimate only incremental cash flows: Only incremental cash flows from an acquisition will add value to the acquiring firm.
- Use the correct discount rate: The discount rate should be the required rate of return for the incremental cash flows associated with the acquisition.
- Be aware of transactions costs: These will include fees to investment bankers, legal fees, and disclosure requirements.

Acquisition and EPS

- Acquisition may look like it creates EPS growth
- Suppose Alpha Corp. acquires Beta Corp. but the merger creates **no additional value**

	Alpha Cop. before merger	Beta Corp. before merger	The market is smart	The market is fooled
EPS	$1	$1	$1.43	$1.43
Price/share	$25	$10	$25	$35.71
PE ratio	25	10	17.5	25
# shares	100	100	140	140
Total earnings	$100	$100	$200	$200
Total value	$2500	$1000	$3500	$5000

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Acquisition may look like it creates EPS (earnings per share = total earnings/total shares) growth

- Suppose Alpha Corp. acquires Beta Corp., **but the merger creates no additional value**; after the merger:
  - Alpha will have 140 shares outstanding (let's say they offered 1 share of Alpha for every 2.5 shares of Beta).
  - Market value of the combined firm is $3,500 = Va of $25/sh * 100 shares + Vb of $10/sh * 100

shares

- Earnings per share of the merged firm are $1.43 (total earnings of $200/140 outstanding shares) = 1.43

- Because the stock price of Alpha after the merger is the same as before the merger, the price-earnings ratio must fall. Here we assume that the market is smart
  - A's PE pre-merger was market price/earnings per share (EPS, or total earnings of $100/# shares of 100 = $1 per share)
  - $25/$1 = 25
  - B's PE pre-merger was also $1 ($10 market price/$1 EPS
  - Post-merger PE of combined firm A's original market price of $25/combined EPS of 1.43 = 17.48

BUT, what if the market is fooled and assumes that the PE ratio doesn't change?

Under that assumption, we take the original PE and multiply by the EPS and we gat 25 * $1.43 for a "fooled" market price of $35.71 per share for the combined firm.

- If the market is "fooled," it might mistake the 43% increase in earnings per share for true growth, in which case the price-earnings ratio of Global may not fall after the merger.
- Suppose the price-earnings ratio of Alpha remains equal to 25.

- Because the combined firm has earnings of \$200, the total value of the combined firm will increase to \$5,000 (= 25 × \$200).
- Per-share value for Alpha will increase to \$35.71 (= \$5,000/140).

Diversification

- Diversification is commonly mentioned as a benefit of a merger, but on its own, no value is created
  - Recall that diversification reduces unsystematic risk
- Stockholders can get all the diversification they want by buying stock in different companies.
- Not uncommon to see firms with surplus cash articulating a "need" for diversification.

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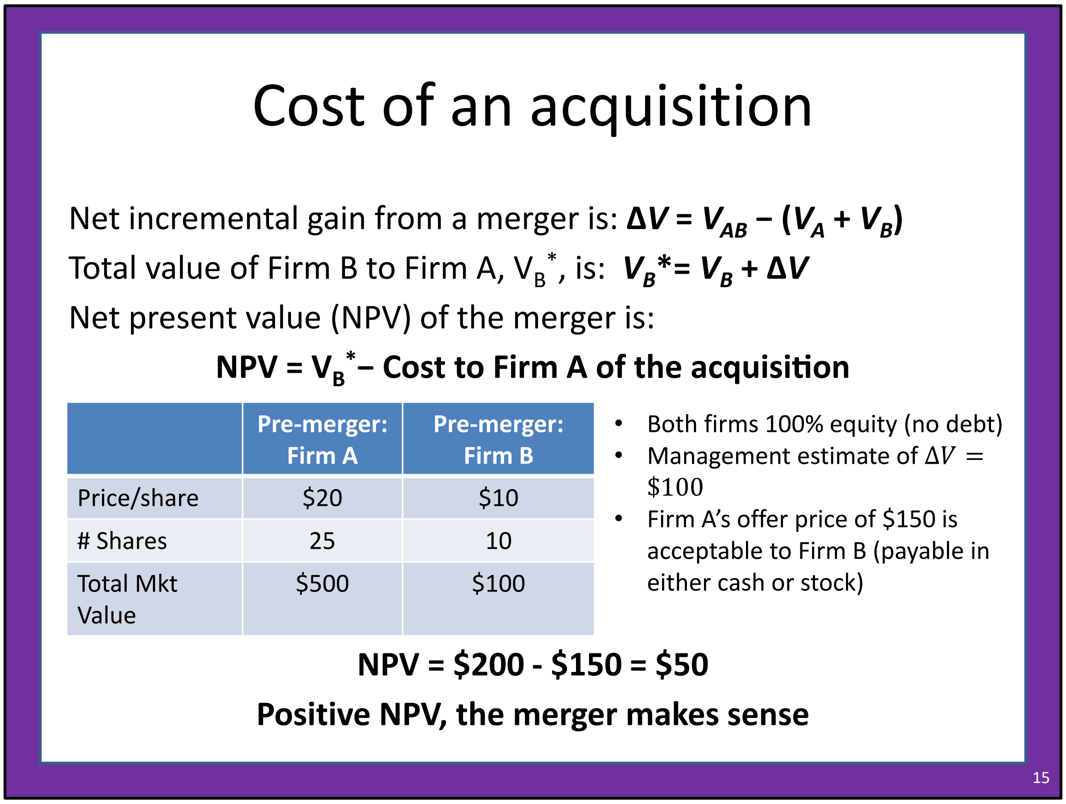
Diversification is commonly mentioned as a benefit of a merger, but diversification per se probably does not create value.

- Recall that diversification reduces unsystematic risk.
  - Value of an asset depends on its systematic risk, and systematic risk is not directly affected by diversification.
  - Because the unsystematic risk is not especially important, there is no particular benefit from reducing it.
- Stockholders can get all the diversification they want by buying stock in different companies.
  - As a result, they won't pay a premium for a merged company
- Firms with excess cash may discuss a "need" for diversification, as a shareholder, you don't need it



- We know that the incremental gain from a merger is $\Delta V = V_{AB} - (V_A + V_B)$
- Recall that Vb*, the value of Firm B (target) to Firm A (acquirer) = Vb* = Vb + Δ*V*
- *NPV*, is the value of the target to the acquirer minus the price paid or cost of the acquisition

- We are given that both firms are 100% equity (no debt). This is going to be the assumption in all of our examples in this unit to keep things simple.
- Firm A's management has estimated the incremental value Δ*V* to be $100
- Because the pre-merger value of A doesn't change, all we need for NPV here is Vb* - cost of the acquisition
  - Vb* = market value of $100 + Δ*V* of $100 = $200
  - NPV = $200 - $50 = $50 The merger makes economic sense

- Where does the positive NPV come from? By paying the target less than the full amount of the synergy gained, the acquiring firm nets a positive outcome.
- The amount over the target's market value that is paid in the acquisition is the "**merger premium**". It is by compensating target shareholders for less than the full synergistic benefit that gains are accomplished.
- Here, the synergistic gain, ΔV, is $100 and the market value of Vb = $100, however, the

target is offered $150, that is $50 over the market value, which is the minimum the shareholders demand. In addition, the bidder is splitting the incremental value with the target.

- The **merger premium** is the amount offered, $150, less the market value of $100 for a premium of $50.

Should Firm A pay in cash or stock?

- Should Firm A acquire Firm B? Should it pay in cash or stock?
  - **Cash offer: NPV = Vb* − Cost = $200 − 150 = $50**
    - After the merger, Firm AB will still have 25 shares outstanding
  - Value of (combined) Firm A after the merger is: Vab = Va + (Vb* − Cost)
  - Vab post-merger = $500 + 200 − 150 = $550
  - Price per share after merger is $550/25 shares = $22, representing a gain of $2 per share.
- Now, what about payment with stock?
  - Vab = Va + Vb + ΔV = $500 + $100 + $100 = $700
  - To give $150 in stock, Firm A gives up $150/20 per share = 7.5 shares
  - Post-merger shares = original 25 for A + 7.5 newly issued = 32.5 shares
  - Price per share = $700/32.5 = $21.54 per share
  - Value to Firm B shareholders = 7.5 sh * $21.54 = 161.54
  - **NPV changes, Vb* - cost = $200 – 164.54 + $38.46**

Go with method that has the higher NPV: Pay cash!

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Should Firm A acquire Firm B? Should it pay in cash or stock?

As shown on previous slide and the accompanying notes

NPV = VB* − Cost = $200 − 150 = $50

Should Firm A use cash or stock for the transaction?

- After the merger, Firm AB will still have 25 shares outstanding
- Value of Firm A after the merger is: VAB = VA + (VB* − Cost) = $500 + 200 − 150 = $550
- Price per share after merger is $550/25 = $22, representing a gain of $2 per share.

Value of merged firm in this case will equal the premerger values of Firms A and B plus the incremental gain from the merger, ΔV:

- VAB = VA + VB + ΔV
- = $500 + 100 + 100
- = $700
- To give $150 worth of stock for Firm B, Firm A will have to give up $150/$20 = 7.5. shares.
- After the merger, there will be 25 + 7.5 = 32.5 shares outstanding, and the per-share value will be $700/32.5 = $21.54.

- Total value of consideration received by B's stockholders is 7.5 × \$21.54 = \$161.54.
- NPV of the merger to Firm A is:
- NPV = VB* − Cost
- = \$200 − 161.54 = \$38.46

In this case, the cash acquisition is better. We chose the higher NPV as the appropriate payment method.

Exam prep, see the **example problems with videos and practice problems in Moodle**

- You will need to be able to calculate the following for the exam:
- Merger premium
- Minimum synergistic value
- Va, Vb, Vab, ΔV, and NPV of the merger
- EPS of the combined firm

The example problems, each with full narrated solutions are comprehensive problems covering multiple concepts in each. **They are intended to provide the info you need for all practice problems (which are closer to what you would see on the exam).**

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Cash vs. common stock

- Distinction between cash and common stock financing in a merger is an important one.
  - If using cash, cost of acquisition is not dependent on acquisition gains.
  - All else equal, if common stock is used, cost is higher because Firm A's shareholders must share acquisition gains with shareholders of Firm B.
- Whether a firm should finance an acquisition with cash or with shares of stock depends on several factors, including the following:
  - Sharing gains
  - Taxes
  - Control
- Cash financing is more common than stock financing

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Whether a firm should finance an acquisition with cash or with shares of stock depends on several factors, including the following:

- Sharing gains: If cash is used to finance an acquisition, selling firm's shareholders will not participate in potential gains from the merger.
- Taxes: Acquisition by paying cash often results in taxable transaction, while acquisition by exchanging stock is usually tax-free.
- Control: Acquisition by paying cash does not affect control of acquiring firm, while acquisition with voting shares may have implications for control of merged firm.

- Typically, cash financing is more common than stock financing

Defensive tactics

- Take advantage of the corporate charter
- Negotiate standstill agreements
- Offer targeted repurchase
  – Aka "greenmail"
- Adopt "poison pill" provisions
  Adopt share rights plans

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In the event of a hostile takeover, that's where target firm does not want to be acquired, there are a number of potential defensive tactics that can be employed:

The **corporate charter** consists of the articles of incorporation and corporate bylaws that establish the governance rules of the firm.

- Firms frequently amend corporate charters to make acquisitions more difficult via super-majority* amendments and classified boards*.
  - These agreements usually lead to the end of a takeover attempt.
- Standstill agreements often occur at the same time that a **targeted repurchase** is arranged.
  - In a **targeted repurchase**, a firm buys a certain amount of its own stock from an individual investor, usually at a substantial premium.
  - These payments made to potential bidders to eliminate unfriendly takeover attempts are referred to as **greenmail**.
- A **poison** pill is a financial device designed to make unfriendly takeover attempts unappealing, if not impossible.
  - Majority of the largest firms in the U.S. have adopted poison pill provisions, often calling them share rights plans (SRPs) or something similar, though SRPs differ quite a bit from company to company.
  - **Share rights plans** are provisions allowing existing stockholders to purchase stock at some fixed price should an outside takeover bid come up, discouraging hostile

takeover attempts.

    - Generally, when a company adopts an SRP, it distributes share rights to its existing stockholders that allow shareholders to buy shares of stock (or preferred stock) at some fixed price.

THE FOLLOWING IS TO PROVIDE MORE CONTEXT AND BACKGROUND, NOT DETAILS YOU NEED TO BE MEMORIZING

- *More background on poison pills*
    - *A shareholder rights plan, colloquially known as a "poison pill", is a type of defensive tactic used by a corporation's board of directors against a takeover.*
    - *In the field of mergers and acquisitions, shareholder rights plans were devised in the early 1980s as a way to prevent takeover bids by taking away a shareholder's right to negotiate a price for the sale of shares directly.*
    - *Typically, such a plan gives shareholders the right to buy more shares at a discount if one shareholder buys a certain percentage or more of the company's shares.[1] The plan could be triggered, for instance, if any one shareholder buys 20% of the company's shares, at which point every shareholder (except the one who possesses 20%) will have the right to buy a new issue of shares at a discount. If all other shareholders are able to buy more shares at a discount, such purchases would dilute the bidder's interest, and the cost of the bid would rise substantially. Knowing that such a plan could be activated, the bidder could be discouraged from taking over the corporation without the board's approval, and would first negotiate with the board in order to revoke the plan.*
    - *The plan can be issued by the board of directors as an "option" or a "warrant" attached to existing shares, and only be revoked at the discretion of the board.*
- *New varieties of poison pills have appeared in recent years:*
    - *“Chewable” pill, common in Canada but not in the U.S., is a pill that is installed by shareholder vote and can be redeemed by shareholder vote.*
    - *“Deadhand pill” explicitly gives directors who installed the pill, or their handpicked successors, authority to remove the pill.*
    - *Controversial because it makes it virtually impossible for new directors elected by stockholders to remove an existing poison pill.*
- *Method of circumventing poison pills has grown in popularity.*
    - *Hedge funds or other large investors, all of whom have the same agenda, band together and purchase a large block of stock.*
    - *They then vote to remove the board of directors and company management without triggering the poison pill provision.*

* A **supermajority**, qualified majority, or special majority is a requirement for a proposal to

gain a specified level of support which is greater than the threshold of more than one-half used for a simple majority.

* A **classified board** is a structure for a company's board of directors (BOD) in which some directors serve for different term lengths, typically of between one and eight years, depending on their particular classification. Under a classified system, longer terms often awarded to more senior board positions (i.e., the chair of the board). A typical classified board will have three to five classes of positions on the board, each carrying terms of service that vary in length, allowing for a staggering of elections.

Other defensive tactics: Going private and leveraged buyouts

- Going private – publicly owned stock is replaced with complete equity ownership by a private group
  - This defensive tactic means that tender offers are eliminated (no publicly held shares)
- Leveraged buyout (LBO) or management buyout (MBO)

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- Going private is what happens when the publicly owned stock in a firm is replaced with complete equity ownership by a private group, which may include elements of existing management.
  - Firm’s stock is taken off the market (if it is an exchange-traded stock, it is delisted) and no longer traded.
- One result of going private is that takeovers via tender offer can no longer occur because there are no publicly held shares.
- In this sense, a leveraged buyout (or more specifically, a management buyout, or MBO) can be a takeover defense, but it’s a defense only for management.
  - A leveraged buyout (LBO) is one company's acquisition of another company using a significant amount of borrowed money (leverage) to meet the cost of acquisition. The assets of the company being acquired are often used as collateral for the loans, along with the assets of the acquiring company.
- From the stockholders’ point of view, an LBO is a takeover because they are bought out.

What does research say about M&A, does it pay?

- M&A pays for **target firm shareholders**.
  - Premium typically paid by bidders represents an immediate, relatively large gain, often on the order of 20% or more.
- Shareholders in bidder firms seem to neither win nor lose very much, at least on average. Why?
  1. **Anticipated merger gains may not be completely achieved**, and shareholders experience losses.
  2. The **bidding firms are usually much larger** than the target firms.
  3. Management may **not be acting in the interest of shareholders** when it attempts to acquire other firms.
  4. Market for takeovers may be **sufficiently competitive** that the NPV of acquiring is zero because the prices paid in acquisitions **fully reflect the value of the acquired firms**.
  5. Announcement of a takeover **may not convey much new information** to the market about the bidding firm.

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Available evidence suggests that target stockholders make significant gains—more in tender offers than in mergers. On the other hand, bidder stockholders earn comparatively little, breaking even on mergers and making a few percent on tender offers.

Divestitures

- **Divestiture** is the sale of assets, operations, divisions, and/or segments of a business to a third party.
- In some cases, particularly when the desired divestiture is a relatively large operating unit, companies will elect to do an **equity carve-ou**t, the sale of stock in a wholly owned subsidiary via an IPO.
- Instead of a carve-out, company can do a **spin-off,** the distribution of shares in a subsidiary to existing parent company stockholders.
- Company can also elect to do (or be forced to do) a **split-up**, the splitting up of a company into two or more companies.

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For a variety of reasons, companies often wish to sell assets or operating units. For relatively large divestitures involving operating units, firms sometimes elect to do carve-outs, spin-offs, or split-ups.

- Divestiture is the sale of assets, operations, divisions, and/or segments of a business to a third party.
    - Following a merger, it is very common for certain assets or divisions to be sold.
    - Occurs when a company decides to sell off a part of itself for reasons unrelated to mergers and acquisitions.
    - Cash-strapped firm may have to sell assets to raise capital (this commonly occurs in bankruptcy).

Next 2 slides are background and jargon related to M&A, these won’t be on the exam, but are a good idea for MBAs to be aware of

Other terms related to corporate takeover

- **Golden parachute**: Some target firms provide compensation to top-level managers if a takeover occurs.
- **Poison put** is a variation on the poison pill described earlier.
- **Crown jewel**: Firms often sell or threaten to sell major assets—crown jewels—when faced with a takeover threat (that is scorched earth strategy).
- **White knight**: A firm facing an unfriendly merger offer might arrange to be acquired by a different, friendly firm.
  - The firm is thereby rescued by a “white knight.”
- **Lockup** is an option granted to a friendly suitor (a white knight, perhaps) giving it the right to purchase stock or some of the assets (the crown jewels, possibly) of a target firm at a fixed price in the event of an unfriendly takeover.

Yet more terms and jargon

- **Shark repellent** is any tactic (a poison pill, for example) designed to discourage unwanted merger offers.
- **Bear hug** is an unfriendly takeover offer designed to be so attractive that the target firm's management has little choice but to accept it.
- **Fair price provision** is a requirement that all selling shareholders receive the same price from a bidder.
- **Dual-class capitalization**: Some firms have more than one class of common stock and that voting power is typically concentrated in a class of stock not held by the public.
- **Countertender offer**: Better known as the "Pac-Man" defense, the target responds to an unfriendly overture by offering to buy the bidder.

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Last exam

- The final exam covers only material from weeks 6 and 7
- 15 questions
- 1 hour
- Same allowed notecard and calculator as for all prior exams
- Exam will be open from week 7, Thursday morning at 1 AM and must be completed by Saturday at midnight, all times Central