Chapter 23
Mergers and the Market for Corporate Control
What Is Control Worth

- Maximum a company is worth as a “stand-alone” company is its value if it were managed efficiently

- Value gap is the difference between this value and the company’s current market value
Reasons to Pay a Premium to Gain Control

- Manage a company more efficiently
- Synergy that might be achieved by combining with another company
  - Economies realized through a merger
- Value of combining companies A & B

\[ V_{ab} = V_a + V_b + \text{Synergy} \]
Features of a Merger

- Acquire only the assets of a company without assuming any of the liabilities
- Acquire the stock of another company assuming its assets and liabilities
- Purchase with cash or stock
- Purchases made with cash or debt are taxable
- Purchases made with voting preferred or common stock are not taxable at the time of sale
  - Capital gain or loss is recognized only when the stock is sold
Accounting Treatment

- In a state of change with FASB exploring the elimination of pooling of interests
- In a purchase the buyer treats the acquired company as an investment
  - Tangible assets are reported at fair market value making it possible to write up the acquired company’s tangible assets
- In a pooling of interests, the balance sheets of two companies are combined, with assets and liabilities being added together
• An Example Suppose Lambda Corporation acquires Phi Zeta Inc. in an exchange of stock valued at $2 million. Phi Zeta had debt of $1 million and shareholders' equity of $1.2 million prior to the merger, with a net sets of $2.2 million. The larger Lambda Corporation, the acquirer had shareholders' equity of $30 million, debt of $5 million, and assets having a net book value of $15 million prior to the merger.
<table>
<thead>
<tr>
<th></th>
<th>Before Merger</th>
<th>After Merger</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Lambda</td>
<td>Phi Zeta</td>
</tr>
<tr>
<td>Net Tangible Asset</td>
<td>15,000</td>
<td>2200</td>
</tr>
<tr>
<td>Goodwill</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Total Assets</td>
<td>$15,000</td>
<td>$2200</td>
</tr>
<tr>
<td>Debt</td>
<td>5,000</td>
<td>$1,000</td>
</tr>
<tr>
<td>Shareholder equity</td>
<td>10,000</td>
<td>1,200</td>
</tr>
<tr>
<td>Total liabilities +</td>
<td>$15,000</td>
<td>$2,200</td>
</tr>
<tr>
<td>Equity</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
With purchase accounting, the total assets of the acquired company, Phi Zeta, are written up by $0.8 million, which is the price paid for the company in excess of its book value. Part of this figure, $0.3 million, can be treated as a write-up of tangible assets to their fair market value. However, the remainder, $0.5 million, must be reflected as goodwill.
Therefore, we have under purchase accounting (in thousands)

If no impairment is felt to occur, the $0.5 million in goodwill will remain on the balance sheet as an asset. It need not be written down against future income. If $0.2 million is viewed to be impaired over the next 10 years, Lambda PZ Corporation will need to amortize against earnings $20,000 a year.
At the end of 10 years, assuming there are no other acquisitions, goodwill will be $0.3 million. Most corporate executives will argue against goodwill impairment for the simple reason that they want future accounting earnings to be as high as possible. The challenge to the accounting profession is to come up with standards for determining impairment.
Strategic Acquisition Involving Stock

• Occurs when one company acquires another as part of its overall strategy
• With a stock acquisition, a ratio of exchange occurs, denoting the relative value weightings of the two companies with respect to earnings and to market prices
• Initial increases and decreases in EPS are both possible
• Possibility of a future growth in earnings owing to the merger
Market Value Effect

- Major emphasis in the bargaining process is on the ratio of exchange of market prices per share.

\[
\text{Market price per share of acquiring company} \times \text{# of shares offered} = \text{Market price per share of acquired company}
\]

- Acquiring company must offer a price in excess of the current market price per share to motivate the company being acquired.
<table>
<thead>
<tr>
<th></th>
<th>Company A</th>
<th>Company B</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Earnings</strong></td>
<td>20,000,000</td>
<td>5,000,000</td>
</tr>
<tr>
<td><strong>Shares</strong></td>
<td>5,000,0000</td>
<td>2,000,000</td>
</tr>
<tr>
<td><strong>Earnings per share</strong></td>
<td>$4.00</td>
<td>$2.50</td>
</tr>
<tr>
<td><strong>Price of Stock</strong></td>
<td>$64.00</td>
<td>$30,00</td>
</tr>
<tr>
<td><strong>EPS</strong></td>
<td>16x</td>
<td>12x</td>
</tr>
</tbody>
</table>
Assuming total earnings stay the same. If $40 a share is offered for company B (a 33 premium) in an acquisition involving the exchange of stock, the exchange ratio is 40/64 or .625. Company B shareholder will therefore receive 1,250,000 of stock in company A in exchange for their Company B shares.
Company A’s EPS as a result of the merger is the same. Company B's former stockholders now hold .625 shares of A for each stock of Company B’s they held. Thus, the earnings per share on each share of Company’ B’s stock they had held is (.625)(4.00), or $2.50 which is the same as before. The book has examples of EPS both above and below the $40 share price. Above favors company B’s shareholder below favors company A’s.
Bootstrapping EPS

• If the P/E ratio of the acquiring company stays the same, the market price of its stock will increase
• Increase in EPS through acquisition
• Unlikely that the market will hold constant the P/E ratio of a company that cannot demonstrate growth potential in ways other than acquiring companies with lower P/E ratios
<table>
<thead>
<tr>
<th></th>
<th>Company A</th>
<th>Company B</th>
</tr>
</thead>
<tbody>
<tr>
<td>Earnings</td>
<td>20,000,000</td>
<td>6,000,000</td>
</tr>
<tr>
<td>Shares</td>
<td>6,000,000</td>
<td>2,000,000</td>
</tr>
<tr>
<td>Earnings per share</td>
<td>$3.33</td>
<td>$3.00</td>
</tr>
<tr>
<td>Price of Stock</td>
<td>$60.00</td>
<td>$30.00</td>
</tr>
<tr>
<td>EPS</td>
<td>18x</td>
<td>10x</td>
</tr>
</tbody>
</table>
Assuming total earnings stay the same. If $40 a share is offered for company B (a 33 premium) in an acquisition involving the exchange of stock, the exchange ratio is 40/60 or .667. Company B shareholder will therefore receive 1,333,333 of stock in company A in exchange for their Company B shares. In this examples company B’s shareholders EPS goes to 2.37 (.667*3.55). They however have a 33% increase in the value of their stock and their earning per share increase to 18 from 10.
<table>
<thead>
<tr>
<th></th>
<th>Surviving Company</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Earnings</strong></td>
<td>26,000,000</td>
</tr>
<tr>
<td><strong>Shares</strong></td>
<td>7,333,000</td>
</tr>
<tr>
<td><strong>Earnings per share</strong></td>
<td>$3.55</td>
</tr>
<tr>
<td><strong>Price of Stock</strong></td>
<td>$63.90*</td>
</tr>
<tr>
<td><strong>EPS</strong></td>
<td>18x*</td>
</tr>
</tbody>
</table>
Bootstrapping Earnings per Share In the absence of synergism, improved management, or the underpricing of Bought Company's stock in an inefficient market, we would not expect it to be in the interest of the Acquiring stockholders to offer a price in excess of Bought Company's current market price. If price stays the same the acquiring companies Price/earning ratio would be 16.9. Acquiring stockholders could be better off if their company's price/earnings ratio were higher than Bought Company's and if somehow the surviving company were able to keep that same higher price/earnings ratio after the merger which would mean a price of $63.90.
# Reasons for a Merger

<table>
<thead>
<tr>
<th>Sales enhancement</th>
<th>Information effect</th>
<th>Wealth transfer</th>
</tr>
</thead>
<tbody>
<tr>
<td>Operating economies</td>
<td>Tax reasons</td>
<td>Hubris hypothesis</td>
</tr>
<tr>
<td>Improved management</td>
<td>Diversification</td>
<td>Management's personal agenda</td>
</tr>
</tbody>
</table>
Valuation Analysis for Acquisitions

- **Equity value-to-book value of the stock**
- **Enterprise value-to-sales**
- **Equity value-to-earnings**
- **Enterprise capitalization-to-EBITDA**
- **Effect on acquiring company’s EPS**
- **Discounted cash flow analysis**
- **Hidden values**
- **PEG ratio = P/E ratio / growth in EPS**
Voting Procedures

- Under majority voting system, stockholders have one vote for each share of stock they own, and they must vote for each director position that is open.
- If management can garner 50.1 percent of the shares voted, it can select the entire board.
- Under a cumulative voting system, a stockholder is able to accumulate votes and cast them for less than the total number of directors being elected.
  - Permits minority interests to elect a certain number of directors.
Formula for Cumulative Voting

- Minimum number of shares necessary to elect a specific number of directors

\[
\text{Total shares outstanding} \times \frac{\text{specific number of directors sought}}{\text{Total number of directors to be elected plus one}} + 1
\]
Thwarting Minority Interests

- Reduce the number of directors to preclude minority interests from obtaining a seat on the board of directors

- Stagger the terms of the directors so only a portion is elected each year
Proxies and Proxy Contests

- Proxy is a form a stockholder signs giving his or her right to vote to another
- Management solicits proxies to vote for a recommended slate of directors and proposals
- Outsiders can seize control of a company through a proxy contest
- Proxy contests are few, owing to management having the upper hand
Dual-Class Common Stock

- To retain control for management, founders, or some other group
- Classified according to voting power and to claim on income
- Superior voting-right stock tends to trade at a premium above the class of stock having inferior voting power
Tender Offers

- Offer to purchase shares of stock of another company at a fixed price per share from stockholders who “tender” their shares.
- Price is usually set significantly above the present market price, as an incentive.
- Allows the acquiring company to bypass management.
- Appeals directly to stockholders are always hostile.
- SEC requires extensive disclosures.
- Under a two-tier offer, the first tier of stock usually represent control and is more attractive in terms of price and/or form of payment.
Company Resistance

- Persuade stockholders that the offer is not in their best interest
- Raise the cash dividend or declare a stock split
- Legal action like an antitrust suit may provide a powerful deterrent to the bidder
- Seek a merger with a “friendly” company, known as a white knight
Antitakeover Amendments

• Managerial entrenchment hypothesis suggests that the barriers erected are to protect management jobs
• Stockholder interest hypothesis implies that corporate control contests are dysfunctional and take management time away from profit-making activities

• Voting devices
  – Stagger the terms of the directors
  – Change the state of incorporation
  – Super majority approval provision

• Poison pill is the most effective of the antitakeover devices
  – Have available a security offering that is unpalatable to the acquirer
Other Antitakeover Devices

- Fair merger price provision coupled with a supermajority provision
- Lock-up provision
- Management contracts such as a golden parachute
- Premium buy-back offer known as greenmail
Takeover Defenses and the Courts

• **Board of directors must be guided by the legal environment in which it finds itself**
  - Exercise good business judgment
  - Act in a way that is fair to all parties
  - Response to a takeover threat must be proportional

• **Present legal environment is one of management having the upper hand in control contests**

• **Some states make hostile takeovers difficult**
Shareholder Proposals and Activism

• Institutional investors and shareholder activist groups want to change the ways of governance
• Want management more responsive to shareholders and the creation of value
• Shareholder proposals usually are submitted under Rule 14a-8 of the SEC
• Puts pressure on management to reform
• Some institutional investors negotiate directly with management
Empirical Evidence on Mergers and Takeovers

• Substantial excess returns to the stockholders of the selling company if the merger or tender offer is successful
• If it fails, share price falls back to the pre-offer level unless there is a subsequent bid
• Hard to make a case for positive excess returns to buying company stockholders, and some recent studies show negative excess returns
• Modest negative share price effects have been found around the announcement of some antitakeover amendments