

THE WHO, WHAT, AND HOW OF M&AS

Introducing Mergers and Acquisitions

Acquisition: When a firm purchases some (or all) of another firm's assets.

An acquisition may also be referred to as a **takeover**.

Merger: When two firms combine assets.

Synergy: The belief that the sum of a firm's parts performs better than they would individually. The two types of synergy are:

1. **Operating synergy:** Operational efficiency is improved by combining multiple parts.
2. **Financial synergy:** Cost of capital is lowered by combining multiple parts.

M&A activity may help with **strategic realignment**, when a company rapidly adjusts to changes in the business environment.

Winner's curse: When the valuation of a target firm is inflated due to overestimation of potential synergies.

Competition among bidders may also result in a company being acquired for more than it's worth.

Acquisitions tend to involve larger firms purchasing smaller ones, while mergers tend to involve firms of similar sizes.

Synergy is the most common reason for M&A activity.

Synergy at Disney

After Disney acquired Pixar, they were able to combine the operations of the two firms and monetize Pixar's content.

Remember: M&A activity may be used to increase a firm's assets or diversify its offerings.

Historical Trends in M&A Performance

Periods of significant M&A activity tend to be followed by periods of less activity; these are known as **merger waves**.

Lessons from merger waves include the following:

- Periods of high economic growth tend to increase M&A activity, while recessions tend to reduce M&A activity.
- Waves can consist of a series of conglomerate creations, friendly or unfriendly acquisitions, and more.

Abnormal returns: Returns not due to systematic or market-wide influences.

Abnormal returns are used to assess shareholder returns during and after M&A activity.

Target firm shareholders tend to enjoy abnormal returns during the premerger phase, while bidding firm shareholders do not.

Merger waves may be caused by shocks in a firm's operating environment, such as:

- deregulation
- technological innovation
- and more!

Cash deals, private target firms, and relatively small bidding firms tend to see increased returns for bidding firm shareholders.

The Stakeholders in M&A

Investment banks (IBs) facilitate the purchase of a company, acting as financial advisors and specializing in raising capital.

They also create **fairness opinions**, third-party assessments of whether the proposed terms are fair to shareholders.

Lawyers are responsible for vetting contracts and ensuring legal compliance, while **accountants** perform financial due diligence.

Activist investors: Institutional or individual shareholders that hold substantial company stock and try to use their influence to affect company policy.

Merger arbitrage: An investment strategy that seeks to capture the difference between a share's market price and the price offered in a proposal.

Hedge funds often play the role of **arbitrageur**, a person or organization that profits by exploiting a market inefficiency.

Antitrust laws: Laws that prevent any one firm from controlling a market.

Fairness opinions are reached by comparing prices of similar acquisitions, analyzing the history of the company's stock, discussing terms with senior management, and more.

Institutional investors include:

Hedge funds: Portfolios focused on highly-liquid assets.

Mutual funds: More regulated portfolios open to the general public.

Private equity funds: Portfolios that focus on large, longer-term investments in companies.

Takeovers

An acquirer is the **parent company**; a target is the **subsidiary company**.

A subsidiary can be either partly or wholly owned.

Acquiring a **wholly owned subsidiary** requires buying 100% of its stock.

Acquiring a **partly owned subsidiary** requires only a **controlling interest**, enough votes to elect the board.

Friendly takeover: When the bidding company is able to negotiate an agreeable deal with the target's board.

When a company does not want to be acquired, the following **hostile tactics** may be used:

- **Tender offer:** Purchasing stock directly from shareholders at a premium.
- **Bear hug:** Making a favorable offer with no warning and a short deadline.

A parent company—also known as a “holding company”—controls the board of its subsidiary company.

Typically, 50.1% is enough for a controlling interest—but the percentage depends on how many shareholders vote.

Other hostile tactics include:

Two-tier tender offer: Offering a higher price for a set percentage of shares.

Litigation: Accusing the board of not upholding their fiduciary duty.

The Cost of Acquisition

Acquisition premium: The price of an offer over the target's current share price.

Free rider problem: A target shareholder's gains may be increased if he waits for other shareholders to sell at a lower price.

There are several strategies the acquiring firm may use to overcome the free rider problem:

- **Toehold purchase:** Buying a small percentage of a company.
- **Leveraged buyout (LBO):** Purchasing a company with mostly borrowed funds.
- **Freezeout merger:** Creating a new company (after a tender offer is accepted), and merging the assets of the target firm into that new company.

Bootstrapping: When cash flows from a target company are used to pay down debt from the takeover.

The acquisition premium is expressed as a percentage.

The free rider problem may cause deals to fall through if no one agrees to sell, or the bidding firm is forced to increase its offer.

Bootstrapping is essentially a way of having the acquired company pay for itself.

Pre- and Post-Offer Defenses

Pre-offer defenses: Tactics to slow down, prevent, or re-negotiate a takeover.

Shark repellents: Amendments to a company's charter or bylaws.

- **Fair price provisions:** Requiring bidders to pay all shareholders the same premium.
- **Golden parachute:** Requiring the acquirer to pay expensive severance packages to management.

A **poison pill**, or **shareholder rights plan**, forces bidders to negotiate with the board of directors.

Flip-in poison pill: Target firm shareholders can buy new shares of the target company at a discount.

Flip-over poison pill: Target firm shareholders can buy discounted shares in the bidding company, post acquisition.

Shark repellents increase board influence, slow board turnover, or limit shareholder power.

Shark repellents include super majority rules, advanced notice provisions, super voting stock, and "for cause" provisions.

Poison pills are triggered by an investor acquiring a certain percentage of the firm's voting stock. They work by diluting the power of the bidding company.

A shadow poison pill is a poison pill that can be used post offer.

Post-offer defenses: Takeover defenses used after a hostile takeover has begun.

- **Debt-based defense:** Taking on large debts post offer.
- **Greenmail:** Paying a hostile bidder a premium for shares.
- A company may **restructure** its assets or legal structure.
- **White knight:** A preferred buyer to the current bidder.

Debt-based defense is also known as leveraged recapitalization.