

11. Corporate Restructuring. Corporate Control. Mergers & Acquisitions

1. Assets and Liabilities Engineering

1.1.1 Corporate Restructuring

The term corporate restructuring pertains to a large range of managerial strategies aimed at increasing firm value. A restructuring often means a reduction in the size of a firm's asset base; in other cases, it may mean changes in the debt or equity of a firm. The former is referred to as asset engineering, and the latter is financial restructuring. A convenient framework for examining corporate restructuring is the balance sheet. Asset engineering refers to changes on the left (assets) side of the balance sheet, and financial restructuring concentrates on the right (claims) side. Asset engineering includes asset sales and liquidations, and asset sales can be divided into various forms of spin-offs, sell-offs, and equity carve-outs. Financial restructuring methods include exchange offers, share repurchases, and „going-private transactions” (leveraged buyouts, or LBOs, and management buyouts, or MBOs).

1.1.2 Asset engineering

Asset sales are the sales of a subsidiary, division, or product line by one company to another. There are three variations of this basic transaction: spin-offs, equity carve-outs, and sell-offs.

1.1.3 Financial restructuring

A going private transaction or a buyout is the transformation of a public corporation into a privately held firm. Such transactions include pure going-private transactions, management buyouts, and leveraged buyouts (LBO). The most commonly cited reason for a going-private transaction is greater managerial efficiency.

The simplest going-private transaction is a **pure going-private transaction**, in which the only group that takes an equity stake in the firm is the firm's management.

Management buyouts (MBOs) are transactions in which a unit's management acquires the unit from its parent firm. Most MBOs are also LBOs, although MBOs are led by the incumbent management team and tend to involve smaller firms.

Leveraged buyouts occur when a small group of investors acquires - primarily through borrowing - the stock or the assets of a formerly public company.

Following a going-private transaction, many firms opt to go public again. This transaction, a secondary initial public offering (SIPO) or a reverse LBO, is one of the most interesting steps in a firm's life cycle.

2. Valuation of Mergers and Acquisitions

2.1 The Market for Corporate Control

The market for corporate control, also known as the takeover market, is a market in which the control rights of public corporations are traded. Corporate control is the set of rights used to determine how corporations are managed. These include strategic investment and financing decisions, the rights to hire and to fire management and other personnel and also compensation decisions.

A takeover is an action that is aimed at acquiring of corporate control. In a takeover market, groups or individuals from both inside and outside the firm bid for the control of desired target corporations. The bidding team seeks to control the target firm in order to increase the firm's value and to maximize stockholder wealth by reducing existing inefficiencies and foster company growth through external expansion. The control of poorly managed firms is often transferred to managers who can more efficiently use the target firm's resources. Takeovers may produce operating advantages through economies of scale, enhanced growth opportunities, facilitate diversification or provide tax advantages. Takeovers may also produce financing advantages through improved debt capacity or lower costs of funds.

2.2 Valuation of takeover projects

Evaluating a prospective takeover is like evaluating any other capital budgeting project. Any of the previously discussed DCF methods may be used. The difference between the value after takeover and the sum of the parts before turnover is just a value added due to takeover. Quite often a term synergy is used to determine this value added. Positive synergy refers to the concept that the whole is greater than the sum of the individual parts. It simply means that the sum of future discounted cash flows after takeover will be greater than the sum of the individual present values before takeover.

In practice the valuation of takeover projects is very difficult. The new cash flows should reflect all uncertain effects of expected reduced inefficiencies, enhanced growth opportunities, diversification and tax advantages. The new cost of capital should reflect the new sources of finance and the altered capital structure. The shareholders of bidding firms obtain only part of the whole value added.

The takeover process may last several months or even years. Expected value added – synergy effect – may change in time.

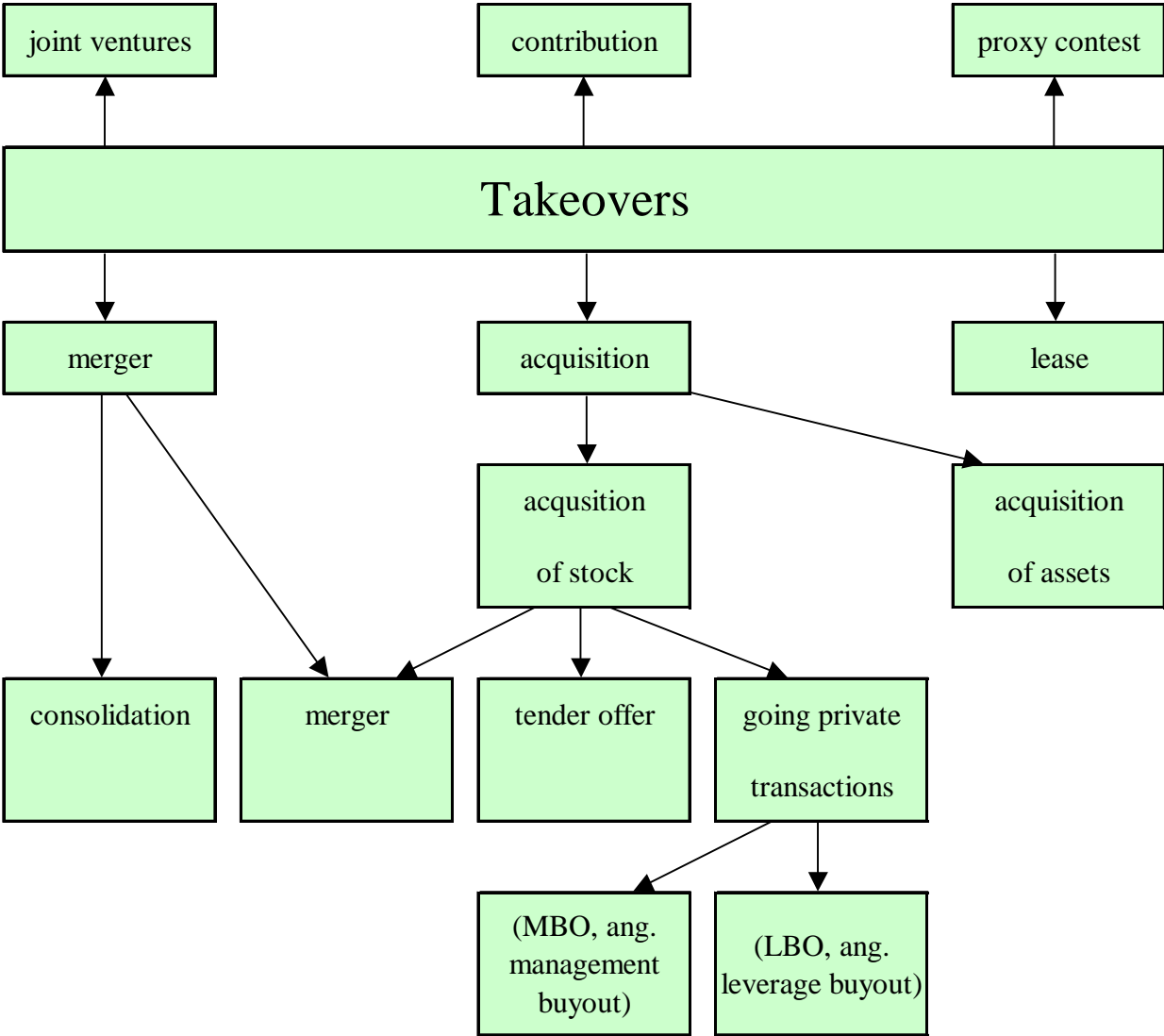
1. The threat of a takeover puts considerable pressure on target management and often minimizes the agency costs.
2. The takeover may be friendly or hostile. Friendly takeovers are supported by the target management. Hostile takeovers are opposed by the target management. The antitakeover measures used to prevent takeovers may decrease the value of the target firm.
3. The distribution of value added between acquiring firm and target may change the expected benefits of the acquiring party.

2.3 Holding company

Takeovers results in creation of holding companies. A holding company is a firm that owns sufficient voting stock in other companies and has effective control over them. A holding company is called the parent company. Controlled companies are called subsidiaries.

2.4 Types of Takeovers

The basic transactions that transfer control rights are mergers, acquisitions, lease agreements, proxy contests, contributions, joint venture.



2.4.1 Merger

Types of Mergers

The term merger is often used loosely to refer to the various business combinations into which a firm can enter (merger in narrow sense or consolidation).

The term merger in narrow sense refers to the combination of two or more corporations in such a way that legally only one corporation survives and the other does not survive in name. The acquiring firm ends up owning the stock or assets of the dissolved (target) firm. Target firm is said to have been merged into acquiring firm. Its shareholders are compensated with cash or shares of the acquiring firm. Congeneric mergers take place when firms have various business relations. They can be classified as either horizontal or vertical. Horizontal mergers engage the combination of two firms that are in the same business. Vertical mergers occur when a firm acquires suppliers or distributors. Conglomerate mergers occur when unrelated businesses combine.

A consolidation occurs when two or more corporations create an entirely new firm. Following a consolidation, neither of the original firms exists as a separate entity.

Bootstrapping of EPS

By merging, an acquiring firm can increase its earning per share in the short run (the „bootstrapping” effect of EPS). This observable „benefit” is however spurious, when the earnings of the combined firms are simply added and fewer shares are issued by acquiring firm to purchase target firm’s stock than were outstanding before the merger. „Bootstrapping” earnings per share cannot add economic value and in an efficient market investors are not „fooled” by this effect.

Terms of Exchange and Merger Value

The acquiring firm must usually offer a premium to the acquired firm’s shareholders which is part of the potential economic value added by the merger. This premium is sometimes referred as the value of an acquiring firm’s control rights. This value is not included in a target firm’s current market stock price and is reflected in the amount that acquiring firms offer that is over and above the market value of the stock.

The value created by the merger is ultimately determined by the market, but the distribution of the potential merger gains depends on the exchange ratio proposed by the acquiring firm or determined during negotiations by the relative bargaining positions of the two firms.

Mergers and Antitrust Prosecutions

A merger with a competing company may reduce competition to the detriment of consumers. The government regulates business practices with antitrust laws designed to protect consumers from the abuses of monopoly power.

The Herfindahl-Herschman Index (HHI) is used to measure market concentration. This index is calculated by summing the squares of the market shares of each of the firms in that particular market. The index ranges from near 0 for a highly diverse market to 10,000 for a highly monopolized market. A market with an index between 1,000 and 1,800 is considered to be moderately concentrated. A market with an index above 1,800 is highly concentrated.

2.4.2 Acquisition of stock

A tender offer is a public offer made by a management team (bidder) to purchase a percentage of the target firm's outstanding common stock. Tender offers do not require the approval of the target firm's board of directors or management. Tender offers are made directly to the target firm's shareholders through public announcements in newspapers.

2.4.3 Proxy contest

A proxy contest is an effort made by dissident shareholders to gain a controlling number of seats on a firm's board of directors. The dissident shareholders' goal is to remove existing directors and to replace them with their own new directors. Dissident shareholders seek votes from other stockholders to elect their own directors. If the dissident group obtains a majority of the board's seats, it has made a change in corporate control.

2.5 Takeover Financing Techniques

Takeovers can be considered as corporate investment projects and they can be financed as any other investment projects. Equity and debt is used. Common and preferred stock, loans, bonds, notes and also other instruments like options and warrants are sometimes offered to „sweeten” the deal for the target firm's shareholders.

In a **cash-for-stock exchange**, the target shareholders receive a cash payment for their shares. The acquiring firm shareholders prefer cash, but the target firm's shareholders do not.

In **stock swap**, the acquiring firm issues additional shares of common stock in exchange for the target firm's outstanding common shares. The target firm's shareholders prefer shares because it is a tax-deferred exchange for them.

The use of junk bonds in financing takeovers was widespread. **Junk bonds** (high-yield bonds) are simply corporate bonds that are either unrated or rated below an investment-grade level. These bonds were known as *fallen angels*. The issuers of the junk bond market were able to obtain great amounts in a very short time. This enabled sharks or raiders to attempt to take over companies even much larger than themselves.

2.6 Strategies to Foil Takeovers

Antitakeover measures are divided into two groups. Proactive (preoffer) measures are antitakeover instruments that can be activated before a raider attempts to takeover a firm. Reactive (postoffer) measures are used after a raider makes an effort to takeover a firm.

2.6.1 Proactive (Preoffer) Measures

Proactive antitakeover measures, sometimes called shark repellents, may reduce the value of stock. The most popular takeover defense mechanisms involve the adoption of bylaw and charter amendments intended to make the transfer of corporate control very difficult. These strategies are also known as porcupine amendments and are important components of takeover defense action.

1. **Staggered board provisions** divide a firm's board of directors into sections so that only one section stands for election each year.
2. **Supermajority merger approval provisions** require approval by an abnormally large share of shareholder votes to enable mergers or other transactions that involve substantial stockholders.
3. **Fair merger price provisions** specify the minimum share prices in mergers that involve major stockholders.
4. **Lockup provisions** are used to prevent the circumvention of the firm's antitakeover provisions. The most popular provision requires supermajority approval to repeal other antitakeover amendments. Another example is a provision limiting the number of directors, which prevents a new majority shareholder from enlarging the size of the board and diluting the current directors' voting power by filling the board with new directors.
5. **Increasing the number of authorized shares of common stock** is a common antitakeover measure. A corporation may also use the newly issued shares to make acquisition of its own.
6. **Golden parachutes** are contractual agreements between top managers and the corporation that guarantee the managers a minimum salary and bonus in the event of a takeover.
7. A **buy-op** is a repurchase of a firm's own shares in the open market over a specified period of time. These shares are often placed in an employee stock ownership plan (ESOP) for later distribution to the firm's directors and employees.
8. **Poison pills** are stock rights plans accepted by a firm's board of directors. They do not require the shareholders' approval. The rights are issued to stockholders and remain inactive until triggered by a tender offer. The exercised rights are used in one of two plans: flip-over plans or flip-in plans. **Flip-over plans** use options to purchase stock in the event of takeover. A typical transaction sets the price of the preferred stock at \$50 and makes it convertible to \$100 of equity. **Flip-in plans** enable the issuing firm to repurchase stock rights from its shareholders at a large premium, usually 100%. The company has to finance such with a new debt and the acquirer is now pursuing a target with higher leverage and much less attractive.

2.6.2 Reactive (Postoffer) Measures

1. A **standstill agreement** is a voluntary agreement between corporation and a significant stockholder that limits the ownership of voting shares in the company to a maximum percentage less than a controlling interest for a specified period of time. Such an agreement is confidential.
2. Standstills are frequently followed by **targeted share repurchases**. At the end of the time specified in a standstill agreement, the firm often buys the large block of shares held by the major stockholder at a substantial premium over the open market price. This premium is commonly known as **greenmail** and is viewed as an incentive to prevent the major stockholder from initiating a takeover bid for the firm.
3. A less common reactive strategy is known as the **Pac-Man defense**, in which the target company initiates a hostile tender offer of its own for the acquiring company. The target becomes the acquirer.
4. The target company searches for a **white knight** to bid for the firm against the original hostile tender offer. The terms usually include a higher price than the original tender offer and more options for the target firm's management.
5. If a target company can identify assets that are attractive to a bidding firm, it may **spin off** these assets to its stockholders. This measure is often called the **crown jewel strategy**.