Payoffs to Stockholders of Target & Bidder Firms

Sources of Gains/Motivations for Mergers

Types of Mergers
  • horizontal
  • vertical
  • conglomerate

Mergers are (generally) friendly
  • they require the approval of both management teams/Boards before stockholders vote

Mergers are often done in an exchange of securities
  • common stock of the bidding firm
  • they are not taxable events for the target stockholders
    • unless they sell the bidder's stock
Interfirm Tender Offers: Basic Facts

Tender offers are (generally) unfriendly
- target management is being by-passed by asking the stockholders to sell their stock, votes etc.

Tenders offers are often done for cash (or new debt securities)
- taxable events for the target stockholders
- strong incentive to complete them quickly
  - reduce the probability that a competing bidder will come along
  - cash/debt is quicker to use than stock

How Do Stock Prices Behave?
Jensen and Ruback (JFE, 1985):

Tender offers:
- bidders gain 4%
- targets gain 30%

Mergers:
- bidders gain 0%
- targets gain 20%
Table 2

<table>
<thead>
<tr>
<th>Sample</th>
<th>Sample Size, N</th>
<th>Returns</th>
<th>Proportion of Sample</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Runup</td>
<td>Markup</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Success</td>
<td>News</td>
</tr>
<tr>
<td>All</td>
<td>1,814</td>
<td>0.133</td>
<td>0.104</td>
</tr>
<tr>
<td>Main</td>
<td>1,523</td>
<td>0.133</td>
<td>0.105</td>
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<tr>
<td>Successful</td>
<td>1,176</td>
<td>0.133*</td>
<td>0.129</td>
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<tr>
<td>Unsuccessful</td>
<td>349</td>
<td>0.090</td>
<td>0.178</td>
</tr>
<tr>
<td>News</td>
<td>699</td>
<td>0.151*</td>
<td>0.079</td>
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<tr>
<td>No News</td>
<td>824</td>
<td>0.118*</td>
<td>0.127</td>
</tr>
<tr>
<td>Poison Pill</td>
<td>229</td>
<td>0.119</td>
<td>0.158*</td>
</tr>
<tr>
<td>No Pill</td>
<td>1,294</td>
<td>0.135</td>
<td>0.092*</td>
</tr>
<tr>
<td>Auction</td>
<td>312</td>
<td>0.127</td>
<td>0.182*</td>
</tr>
<tr>
<td>No Auction</td>
<td>1,211</td>
<td>0.134</td>
<td>0.085*</td>
</tr>
<tr>
<td>Tender Offers</td>
<td>566</td>
<td>0.116*</td>
<td>0.205</td>
</tr>
<tr>
<td>Mergers</td>
<td>959</td>
<td>0.119</td>
<td>0.096*</td>
</tr>
<tr>
<td>MBOs</td>
<td>173</td>
<td>0.105*</td>
<td>0.089</td>
</tr>
<tr>
<td>Cash</td>
<td>931</td>
<td>0.141</td>
<td>0.042</td>
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<tr>
<td>Equity</td>
<td>254</td>
<td>0.028</td>
<td>0.027</td>
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<tr>
<td>Insiders</td>
<td>135</td>
<td>0.183*</td>
<td>0.212*</td>
</tr>
</tbody>
</table>

Why are premiums smaller for targets in mergers? -- Taxes:

(1) Larger premium in tender offers to make target stockholders as well off after taxes

(2) Could be that some of the 'cost' of the bid is used to buy off target management (to get them to cooperate), so the gains to stockholders are smaller

Both of these stories imply that the "pie" is being divided in different ways, with target shareholders getting a smaller piece.
<table>
<thead>
<tr>
<th>Why are premiums smaller for bidders in mergers?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Could be that bidders know that tender offers are more expensive</td>
</tr>
<tr>
<td>• higher premiums required</td>
</tr>
<tr>
<td>• more chance of competition</td>
</tr>
<tr>
<td>• more lawyers/investment bankers fees</td>
</tr>
<tr>
<td>• so they only pursue deals that are likely to have large potential gains</td>
</tr>
<tr>
<td>There are some deals that remain profitable as mergers that would not be as hostile tender offers, so the samples are not comparable</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Where Do the Gains Come From? Horizontal Mergers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Firms producing similar products in similar markets (i.e., the same industry)</td>
</tr>
<tr>
<td>• <strong>Monopoly pricing:</strong> could be gains from reducing competition</td>
</tr>
<tr>
<td>• demand curve facing the firm becomes less elastic</td>
</tr>
<tr>
<td>• price off the marginal revenue curve</td>
</tr>
<tr>
<td>• reduce output, and increase profits</td>
</tr>
</tbody>
</table>
Where Do the Gains Come From?  
**Horizontal Mergers**

Antitrust Division of the Justice Department & the Federal Trade Commission worry about horizontal mergers

- **Monopoly Pricing makes consumers worse off**
- **Efficiency increasing mergers make consumers better off**
  - more output at lower prices

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Where Do the Gains Come From?  
**Vertical Mergers**

Upstream firm buys a downstream firm (or vice versa)

- if one firm has a monopoly, can the merged firm increase profits by charging monopoly prices at both levels?  
  - Generally, NO
- are there efficiency gains from internal rather than external contracting?  
  - it depends: there is still an important transfer pricing problem
### Where Do the Gains Come From? Conglomerate Mergers

**Firms in totally different industries**

- perhaps there are efficiencies in management or some centralized service
  - doubtful today
  - may have been more important when centralized information systems first came into being (1960's)

### Diversification Gains from Mergers Who benefits?

**Not stockholders:**

- they could do it on their own account by buying the stock of the two companies
  - avoid paying a premium
  - their holdings wouldn't have to be in fixed proportions
Diversification Gains from Mergers
Who benefits?

Stakeholders who are forced to hold undiversified portfolios of the stock of the bidder/target firm

- it is hard for them to diversify on their own accounts

- MANAGEMENT

Mergers as Financial Engineering

In the 1960's it was (naively) thought that if a bidder firm with a high P/E ratio bought a target firm with a low P/E ratio, the earnings from the target firm would be capitalized at the higher P/E ratio

- this presumes that firms, not projects, have a cost of capital

- this only makes sense if the target firm's earnings suddenly start growing at a rate that would justify the higher P/E ratio
  - because of efficiency gains?
Where Do the Gains Come From? Efficient Contracting

Gains from mergers/tender offers must come from something that can't be done through direct contracting

• you actually have to buy the firm to realize the gain

Where Do the Gains Come From? Efficient Contracting

If one firm has tax credits (e.g., losses in prior years), the IRS doesn't allow firms to sell these assets

• merger is the only way for a firm with taxable income to be able to use these credits
Where Do the Gains Come From? Efficient Contracting

DuPont said it wanted Conoco for assured access to petroleum as inputs to its chemical production processes

• couldn't it simply sign a long-term supply arrangement?

Where Do the Gains Come From? Efficient Contracting

Sometimes patents, or distribution networks, or brand names are used as rationalizations for mergers

• this assumes that the patent can't be sold or licensed at an efficient price
• that the distribution network can't be used or bought through a joint venture arrangement
• that the brand name from one product will extend to the acquired product
  • Kodak film and Verbatim floppy disks, or batteries
Where Do the Gains Come From?
Efficient Contracting

Tradeoff between whether it is more costly to contract inside versus outside of the firm

Corporate Control always changes

• the decision processes within the target firm

Where Do the Gains Come From?
Summary

(1) From a policy perspective, gains come from either efficiency gains (good), or from monopolization (bad).
  • management shouldn't care, except that the probability of antitrust problems increase if the gains come from monopoly pricing

(2) Should always ask whether it is necessary to merge to capture the efficiency/pricing gains?
  • are other contracting methods better than paying a premium to buy control?
Where Do the Gains Come From?

**Summary**

1. Diversification should not increase firm value

2. Since corporate control always changes, this may be the common factor explaining the gains.
   - replace target management (& their decisions)

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