FIN 540
Interfirm Tender Offers & Mergers

Payoffs to Stockholders of Target & Bidder Firms

Sources of Gains/Motivations for Mergers

Types of Mergers
- horizontal
- vertical
- conglomerate

Interfirm Mergers: Basic Facts

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

Average pre-bid runups (Runup) and post-announcement markups (Markup) for different samples of successful and unsuccessful mergers or tender offers of exchange-listed target firms, 1975-91. Runup is the cumulative abnormal return to the target's stock from day -42 to day -1 relative to the first bid. Markup is the cumulative abnormal return to the target's stock from the day of the first bid through delisting or 126 trading days after the first bid, whichever comes first. The remaining columns show the proportions of each sample in which the target firm is taken over (Success), or there is pre-bid news implying that a bid might be forthcoming (News), or the target firm has a poison pill in place (Pill), or there are multiple bidder auctions (Auctions), or the deal is a tender offer (Tender Offer), or the deal is a management buyout (MBOs), or there is an all-cash payment to target shareholders (Cash), or there is an all-equity payment to target shareholders (Equity), or the S.E.C. later accused someone of engaging in insider trading prior to the takeover (Insiders). The rows show different samples of the data based on the characteristics of the deal. The "main sample" excludes deals that took longer than one year to consummate and target firms whose equity value is small (below $10 million) or whose pre-runup stock price is low (below $2 per share). All of the following samples are subsets of the main sample.

		Returns		Proportion of Sample								
Sample	Sample Size, N	Runup	Markup	Success	News	Pills	Auctions	Tender Offers	MBOs	Cash	Equity	Insiders
All	1,814	0.133	0.101	0.772	0.443	0.136	0.207	0.350	0.112	0.600	0.172	0.079
Main	1,523	0.133	0.105	0.771	0.459	0.150	0.205	0.370	0.114	0.611	0.167	0.089
Successful	1,174	0.143*	0.158	1.000	0.456	0.140	0.192	0.451	0.122	0.636	0.173	0.115
Unsuccessful	349	0.100*	-0.074	0.000	0.470	0.186	0.249	0.097	0.086	0.527	0.146	0.000
News	699	0.151*	0.079	0.765	1.000	0.239	0.265	0.418	0.124	0.624	0.119	0.119
No News	824	0.118*	0.127	0.775	0.000	0.075	0.154	0.330	0.104	0.601	0.208	0.063
Poison Pill	229	0.119	0.176*	0.716	0.729	1.000	0.362	0.520	0.096	0.703	0.096	0.118
No Pill	1,294	0.135	0.092*	0.781	0.411	0.000	0.177	0.344	0.117	0.595	0.179	0.083
Auction	312	0.127	0.182*	0.721	0.593	0.266	1.000	0.532	0.103	0.670	0.074	0.099
No Auction	1,211	0.134	0.085*	0.784	0.424	0.121	0.000	0.329	0.116	0.596	0.191	0.086
Tender Offers	564	0.156*	0.201*	0.940	0.518	0.211	0.294	1.000	0.082	0.817	0.014	0.140
Mergers	959	0.119*	0.049*	0.672	0.424	0.115	0.152	0.000	0.132	0.490	0.257	0.058
MBOs	173	0.105*	0.089	0.827	0.503	0.127	0.185	0.266	1.000	0.763	0.012	0.110
Cash	931	0.141	0.142*	0.802	0.468	0.173	0.224	0.495	0.142	1.000	0.000	0.099
Equity	254	0.092*	0.077	0.799	0.327	0.087	0.091	0.031	0.008	0.000	1.000	0.047
Insiders	135	0.183*	0.212*	1.000	0.615	0.200	0.230	0.585	0.141	0.681	0.089	1.000

Why are premiums smaller for targets in mergers? -- <u>Taxes:</u>

(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

Why are premiums smaller for bidders in mergers?

Could be that bidders know that tender offers are more expensive

- **higher premiums required**
- **more chance of competition**
- **more lawyers/investment bankers fees**
- **so they only pursue deals that are likely to have large potential gains**

There are some deals that remain profitable as mergers that would not be as hostile tender offers, <u>so the samples are not comparable</u>

Where Do the Gains Come From? Horizontal Mergers

Firms producing similar products in similar markets (i.e., the same industry)

- **<u>Monopoly pricing:</u> could be gains from reducing competition**
- **demand curve facing the firm becomes less elastic**
- **price off the marginal revenue curve**
- **reduce output, and increase profits**

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**

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?**
  - **<u>Generally, NO</u>**
- **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

- <u>MANAGEMENT</u>

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

(3) Diversification should not increase firm value

(4) Since corporate control always changes, this may be the common factor explaining the gains.

- replace target management (& their decisions)

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