Good books: Barbarians at the gate

Mid-term: Ch. 1, 2,3,4,5,6,10

# CH1: Introduction

Terminology:

* Consolidation: Business combination whereby two or more companies join to form an entirely new company; combining companies are dissolved and previous shareholders become owners of the new entity. (A+B=C). If the 2 firms differ in size, can be referred to as a merger.
* Merger/Acquisition: One company acquires a second company, typically of smaller size.
* Buyer: company with largest market cap or company issuing shares in exchange for other company’s chares
* Enterprise value: EV =

+ Net debt (debt-cash)

+ Equity (Market Cap, not book)

+ Minority interest

+ preferred shares (market value

+ Off BS liability

– Investment in associates

Types of merger:

* Horizontal:
	+ Typically to accomplish economies of scale or synergies
	+ 2 competitors combine (ex: Exxon/Mobile, Pfizer/Wyeth)
	+ Increase in competitive power can trigger antitrust government opposition.
* Vertical: Companies that have a buyer/seller relationship
* Conglomerate: Companies are not competitors not part of same value chain (like GE)

Merger Consideration:

* Cash, securities or combination
	+ Of acquirer or debentures
	+ Could be registered (can be freely traded), or restricted (can’t be sold on public markets)
	+ If buyers offers stock, can be offered in fixed or floating exchange ratio. If fixed, rate is determined by evaluating average price over pricing period. Offer can also have a collar (max and min # of shares within floating value agreement)
* Earn Out: part of payment is based on performance. Sometimes in a transaction, company might be doing well, but don’t know what you really get until you start running the company. Ex: shoving products down to distributors or franchisees but products inventoried. Sales up but AR hiding.
* Contingent Value Right (CVR): Guarantees some future value if the acquirer’s shares fall below some threshold. Similar to floor on caller
* Holdback provision: some compensation withheld in escrow based upon occurrence of certain events (ex: litigation)

LBO and Private Equity:

* Buyer uses debt to finance acquisition of a company
* Usually term is reserved for privatization of public companies
* Often used for management buyouts

Corporate Restructuring:

* Usually refers to divestitures / asset selloff
* Could also be spin-off and equity carve out

Merger negotiations:

* Typically peaceful ,but could degenerate into withholding bid or hostile takeover
* Most deals have material adverse change clause: allows withdrawal if major change in circumstances occurs which would alter value of the deal
* Initial Agreement: When reach point where there are clear terms upon which buyer is prepared to make an offer the seller might accept, buyer prepares a term sheet
* Term sheet: buyer seller, purchase price, considerations
* May be followed by Letter of Intent (LOI): more details on terms of agreement

Deal Structure:

* Asset Deals: Buyer does not need to take on liabilities
* Entity deals:
	+ Stock transaction:
		- Practical if few shareholders (target SH need to approve the deal, could be disadvantage)
		- Consideration sent directly to SH
		- No convergence issues or contractual restrictions on transfer of assets
		- No appraisal rights (SH who refused the deal go to court and seek delta between deal and true value)
	+ Merger Entity deals:
		- Constituent corporations: entities doing the deal
		- SH voting approval requires; in Delaware; only majority. Varies by state, corporate bylaws can require supermajority
	+ Forward merger (aka statutory merger): Targets merges into purchase and disappears
		- Drawback: voting approval of both SH is required and buyer assumes liabilities. Not common because of drawbacks
	+ Forward subsidiary merger:
		- Purchaser created subsidiary and target merges there
	+ Reverse subsidiary merger:
		- Acquirer subsidiary pays target SH and receives shares of target in exchange
		- Target stays, sub disappears; assets of targets do not move

Approval procedure:

* Send letter of intent
* Due diligence (lawyers & accountants), inspect operations
* BoD of each company reaches an agreement (can hire investment bank to get fairness opinion
* Adopt resolution approving the deal (includes terms of deal)
* Deal taken to SH for approval; proxy of solicitation accompanies with a 14A (terms, reason of transitions, accounting treatment, tax consequence):
	+ Friendly deals typically always approved
* Following approval, merger plans (articles of merger) submitted to secretary of state
* If approved, issues certificate of merger consolidation

Short form merger:

* Does not require SH voting; simply BoD resolution
* Threshold for SH ownership (90% in Delaware)
* Don’t need to go to SCC for approval.

Freeze Outs and Minority SHs:

* If majority voting reaches (51%), minority SH required to tender their shares
* Designed to prevent hold-outs
* Dissident SH can go to court to peruse SH appraisal rights

Reverse merger/IPO:

* Private company goes public by merging with public company (typically empty corporate shell)
* Avoids regulatory requirements, costs and delays of IPO
* Typically much less dilution than IPO, but less capital raised
* Gives company more liquid shares that can be used to purchase other companies (instead of illiquid privately held shares)

Special Purpose Acquisition Vehicles (SPACS):

* Raise capital in IPO where finds earned are for acquisitions
* Aka: blank check or cash shells
* 80% funds put in trust to earn return while looking for deals; 20& WC
* SH approve deals (unlike PE)
* If no deals made in ~2yrs, money returned to investors

Holding company:

* Only purchase controlling interest instead of entire company
* Adv.: Less expensive, no control premium, skip SH approval.
* Disadv.: multiple taxation, still exposed to antitrust

Offers:

* Tender offer: made directly to SH; hostile when made w/o approval of the board.
* Two tier offer (Disallowed now): Offer premium only for controlling shares

# CH2 - History

6 waves, characterized by high levels of mergers followed by quiet periods

First Wave (1897–1904): Industry Consolidation – Monopolies (Horizontal)

* After depression of 1883; development of the U.S. transportation system was another factors: Nationalization of markets
* Crash of 1904, followed by the banking Panic of 1907, closed many of the nation’s banks (paved the way for the formation of the Federal Reserve System) basic financial ingredients fueling takeovers were absent
* Mostly mining and manufacturing industries

Second Wave (1916-1929): Consolidation – Oligopoly (Vertical)

* Started by post WW1 Economic boom
* Stricter antitrust regulation (1914 Clayton Act to reinforce Sherman Act)
* Large scale formation of conglomerates; many vertical mergers

Third Wave (1965-1969): Conglomerate merger

* Diversification / conglomerates; motivated by goal to expand faced with strict anti-trust regulation
* No increase in industrial concentration
* Driven by P/E ratio growth:
	+ Acquirer: P/E 25:1, earning 1M$, 1M shares trading at 25$
	+ Target: P/E 10:1, earnings 0.1M$, 0.1M shares trading at $10
	+ Offer 1 share ($25) for 2 target (2x$10=$20); new issue 50k shares
	+ EPS of acquirer from $1 to $M1.1/1.05M shares = 1.05$/Share
	+ If P/E remains at 25:1, new share price is 25\*($M1.1/1.05M=1.05)= $26.19
* 1968, Attorney General crack down on conglomerates; 1969 Tax Act Reform:

Fourth Wave (1984-1989): Hostile mergers, and megamergers

* Hostility determined by reaction of target board
* % hostile still small, but increased
* $ value of transactions increased
* Appearance of corporate raiders; can also make $ from attempts via greenmail
* Rise of arbitrage; buy target in anticipation of merger, even if original deal fails often result in merger
* Unique characteristics: Aggressive role of investment banker, sophistication of strategies, aggressive use of debt, deregulation
* Ended: mild recession of 90s, collapse of junk bond market

Fifth wave (1992-2000): Roll-Ups and Consolidation of industries, cross borders

* Emphasis on strategy rather than quick financial gains like 80s
* More equity, less leverage
* Roll-Ups: combine small regional players into large national
* Ended by 2001 recession, 9/11 economic shock

Sixth wave (2003-2008): Private Equity, LBO, Shareholder Activism

* Decreasing lending rates = rise in PE deals
* Oil at $18, wave of imports from China
* With all derivative product, central bank lost control of money products. Multiplier effect up the roof because of derivatives
* End with 2008 subprime crisis

# CH 3 - Legal Framework

3 types of merger laws in US: Securities Law, State Corporation Law, Federal Anti-trust law

Securities Law:

* Sec. Exchange Act 1934: Requires providing prospectus and disclosure requirements
* Williams Act (1968):
	+ Regulate tender offers to avoid SH betting rushed to tender shares by 2 tier offers
	+ Provide procedure and disclosure requirements
	+ Provide SH time to make informed decision
	+ Increase confidence in securities markets
	+ Made Churning and cornering markets illegal
	+ Requires particular fillings (8k, s4, 13d, TO)
	+ Response to TO: 14D-9, <10bd of receiving offer

|  |  |  |  |
| --- | --- | --- | --- |
| What | Trigger | Delay | Content |
| 8K | (acq. 10% BV of assets) | < 15d of occurrence of a significant event | Description of asset, nature and amnt of consideration, if acq, source of funds, financials of business acquired  |
| S4 | Need to issue new stock to acquire, 20% or more of existing | Submitted to SEC 10d prior to being sent to SH, must be received 20d+ prior to voting | Large amount of info, typically filed with proxy statement |
| 13(d) (William) | Acq. 5% outstanding stock | Within 10 business days | Alert target of a potential threat to control, state purpose of acquisition, source of funds; might not be for takeover. Disclose all target share transactions 60d prior to offer. Need to disclose current, not when trigger hit; goes public immediately |
| TO (Take Over) | At time declaring tender offer |  | Specific shares to be acquired, background of buyer, 2 years of financial statements form buyer |

Other subsections:

* 14(d) Regulates tender offers
* 14(e) Prohibits material misinterpretations and other improper practices in tender offer solicitation and opposition
* 14(f) Disclosure if share ownership changes result in the replacement of the board of directors without SH approval
* 13(e) Regulates issuer purchases

Response: Within 10d of receiving TO, respond via 14D-9:

* Recommend acceptance
* Recommend Rejection
* State that opinion is neutral
* State that cannot take a position on bid

Definition of a group: 2+ person act as a partnership, LP, syndicate, etc.… For the purpose of acquiring, holding, disposing of securities of an issuer, such group shall be deemed a person for purpose of subsection

* If you are a group, must file if you cross 5% threshold
* Stock parking: Illegal way of trying to avoid the law by putting shares in name of those others than the true owner

Once file 13(d), can no longer buy shares on open market.

Minimum offer period: Tender offer must be opened for SH considerations for 20 days. Bidder must treat all shares tendered equally, and many not actually buy them until the end of 20 business days. (You can pledge shares, but can’t sell them)

Oversubscribed offers and Partial Bids: Must be accepted on a pro-rata basis (ex: offer for 40% but get 80% then accept ½ shares tendered from every SH)

Withdrawal rights: SH may withdraw shares from trust (in case a better bid came up) any time prior to the end of 20 days or later if the offer is extended.

2 tiered tender offers (Aka Front end loaded offers): Offer superior compensation for front end and inferior compensation for back end.  SH rights: Second tier may get frozen out and forces to accept second tier compensation. 1982, SEC said second tier SH can sue to demand fair compensation.

Rule 14D-9: target must **respond within 10 business** days from dissemination of bidder’s offer: acceptance, rejection, neutrality, unable to take position. Respond by 14D-9

Definition of a tender offer - 8 factor test:

* Active and widespread solicitation of public shareholders
* Solicitation made for a substantial % of an issuer’s stock
* Offer to purchase made at a premium over the prevailing market price
* Terms of the offer are firm rather than negotiated
* Offer contingent on the tender of a fixed number of shares, often subject to a maximum # to be purchased
* Only open for a limited period of time
* Offeree subject to pressure to sell his stock
* Public announcement of a purchasing program concerning the target company proceeds or accompany rapid accumulation of a larger amounts of the target company’s securities

Changes in offers:

* Significant changes in the offer:
	+ Considered a new offer (ex: higher price)
	+ New offer provides 20 business days
* Amended offer (less significant change): change in # shares to be bought, change in % cash/stock compensation - requires 10 business days

Best price rule (14d-7): If a bidder increases the consideration, he has to give it to all those who have already tendered shares

Competing tender offers:

* If receive competing offer, automatically extends original 20d window to consider original offer
* SH can withdraw shares

Mini tender offer:

* Offers for less than 5% of equity
* Less regulated, no disclosure requirements

Loopholes in Williams act:

* 10 day window: Bidder can buy large position in this period
* 5% threshold: Bidder may be on the way to becoming a dominant SH after acquiring this many shares (if company ownership is distributed)
* Proposed solution: shorten 10 day period, lower 5% (was already lowered from 10%)

Business Judgement Rule: managers and directors must exercise reasonable diligence in the corporate oversight process. Directors can only try to prevent take over if it can be shown that there was a threat to corporate policy and the defensive measure adopted was proportional and reasonable given the nature of the threat.  (Act in best interest of SH, not directors)

Revlon duties: Come into play when certain that sale is inevitable; directors:

* Have a duty of loyalty
* Have to demonstrate care for interest of shareholders
* Carry duties in a way that is in best interest of corporation and SH

State antitakeover laws: Federal oversees securities, tender offers and antitrust, states govern corporate charters and bylaws

* Fair price provision: Ensures no two tier bids
* Business combination provision: prevents agreement between buyer and seller; avoid heavy LBO and use of sale of target assets to cover debt payment
* Control share provision: acquirer needs target SH approval before purchases passed a % are allowed.
* Cash out Statutes (aka control transaction statutes): Requires purchaser of more than a certain threshold % to purchase the remaining shares of all the other SH at the highest premium paid for the shares the acquirer bought
* Constituency Provisions: Allows board to take into account other stakeholders

Delaware: Most popular state for incorporation:

* Well-developed law and legal precedents
* Cheap incorporation fees
* Better court system
* non-residency requirements
* Nevada trying to supplant Delaware’s position:
* Copied DW corporate laws
* Accept DW case precedents
* Effort was not successful

Antitrust law

Sherman Act:

* Section 1: All contracts and combinations in restraint of trade are illegal
* Section 2: All monopolies and attempts at monopolization are illegal

Clayton Act:

* Strengthen Sherman act (didn’t have enough teeth originally) by clarifying which business practices restrain trade and reduce competition
* Loophole permitting monopoly takeovers via asset purchases

Hart-Scott-Rodino Antitrust Improvement Act:

* Avoid the closing of transactions that would be judged anticompetitive
* Gives FTC and Justice dept. power to request economic data
* to request

HH Index Herfindahl-Hirschman:

Sum of square of market share that each firm has in the industry. Gives a more quantitative look of the market since larger firms given larger representation than smaller firms. Post-merger HH:

* HH>1800: Highly concentrated industry; shift by 50 = issue
* HH>1000: Moderately concentrated; shift by 100 = issue
* HH<1000: Not concentrated; unlikely to cause antitrust challenge

13d - when filing with SEC, goes public immediately. When filing, need to divulge exact position, not position that was accumulated when hitting original 5%

# Chapter 4- Merger Strategy

Determinants of merger

1. Growth: Can’t grow organically fast enough - buy external either in same industry or complementary, or conglomerate. Large companies, less innovation. Critical issue with buying company is price paid to achieve rapid growth. Especially if dealing in a hot market
2. Operating Synergies: Spread indirect OH costs across more products & Economies of Scale. Eventually produces demising returns on incremental input. 2 types:
	1. Cost reductions: easiest to quantify and plan (sell off jets, close plants, etc.…).
	2. Revenue enhancing, cross selling a product: Harder to achieve and really hard to quantify
3. Financial synergies: Larger companies = lower cost of capital. Problem is, purchaser needs to fork out cash or generate debt to finance deal. Might lower cost of capital but increases debt, therefore 2 companies combined have more debt than 2 of them before the deal.
	1. Problem with debt co-insuring. Financially stable buys less stable company. Using internal cash to finance debt. People benefiting are people who own the debt. Financing company will sue their reserves to assume debt. Take away some cash that otherwise would have come as a cousin for acquirer. Not a win/win all around.
4. Diversification:
	1. Acquire Industry position
	2. Enter more profitable industries

# CH 5 - Antitakeover Measures

2 types:

* Preventative (defense installed in advance of takeover, exercise in Wall Building)
* Active (Defensive deployed during takeover battle)

Common Preventative:

* Poison pill/Shareholder Rights Plan: Securities issues by target to make firm less attractive.
	+ Shadow pill: Not need pre-existing
	+ Chewable pill: Pill disappear or is redeemable by shareholders rather than only by boards
	+ Typical: shareholder rights plan involves a scheme whereby SH have the right to buy more shares at discount, if one SH buys a certain % of the company’s share. Could be triggered when any one SH buys 20% of company’s shares, at which point never SH has the right to buy a new issue of shares at discount. Dilution = high cost of acquisition
	+ Types:
		- Flip-over:
			* Call options paid as dividends to existing SH
			* Triggering event (20% by a group, or tender offer to 30%+)
			* Only effective if acquirer buys 100%
		- Flip-In:
			* Prevent takeover of control <100%
			* Flip-in provisions allow holders of rights to acquire stock in the target, as opposed to flip-over rights, which allow holders to acquire stock in the acquirer
			* designed to dilute the target company regardless of whether the bidder merged the
		- Voting Plans:
			* Company issues dividends in preferred stock
			* If any outside entity acquires a specified % of target’s stock, holder of preferred gets super voting right
			* Legality have been successfully challenged
* Corporate charter amendment: (Corporate Bylaws = when directors meet and location of SH meeting; Corporate charter aka article of incorporation = classes of shares)
	+ Supermajority provisions:
		- Require higher than normal majority vote approval for certain events
		- Board out clauses allows the target board to cancel this provision (without target directors representing the bidding firm allowed to vote)
	+ Staggered board (aka Classified Boards): Slows down decision making, but new company will be stick with board members for few years.
		- All directors do not come up for election at the same time (ex:⅓ at a time)
		- Bidder can only get majority control after 2 elections (years)
		- Requires shareholder approval
	+ Dual Capitalization (aka alphabet stock):
		- Multiple classes of stock - one with super voting rights
		- Issuance: all SH given high voting rights (low dividend shares), the SH are offered regular dividend shares for high voting shares if they want to exchange
		- Why SH want: most shareholders are more interested in higher dividends than voting rights; those who want control won’t exchange
	+ Fair price provision:
		- SH amendments which require bidder to pay fair price for all shares acquired
		- Fair may be:
			* Certain P/E
			* Highest price paid for shares
			* Highest price stock traded for over past year
			* Same as those in first tier
		- Less popular as many states have fair price statutes
	+ Reincorporation:
		- Reincorporate in a new state which has stronger antitakeover laws (ex: California or Pennsylvania)
		- Long, not practical
	+ Anti-greenmail provisions:
		- During time of raiders, go in and buy 20% of company and threaten to takeover. Offer to go away quietly if management repurchases interest (ex: buy 20% at 20$, offer to go away if resell at $30)
		- Prohibits payment of greenmail
		- New legislation, if greenmail, pay 50% tax and company that paid can’t deduct from taxes.
		- Lots of corps have in their charter not to pay GM
* Golden parachutes

Active Antitakeover Defense:

* Greenmail: Payment of a premium to buy shares of threatening SH
* Anti-greenmail: Act of doing, not the provision, is active
* Standstill agreement: Payment to threatening SH not to purchase more shares
* White knight: Friendly buyer preferred to hostile buyer that takes over company
* White Squire: Friendly buyer of a block of stock, similar to white knight, but doesn’t buy controlling interest
* Lock up Transactions: Sale of assets that make target less desirable. Need to be cautious because SH or acquirer can take you to court (destroy company not in best interest of SH)
* Lock-up Options: Gives potential buyer right to buy certain assets at an attractive price
* Capital Structure Changes: Tie-up shares or alter leverage
	+ Issues more shares (general, white squire, ESOP). Could issue more treasury stock for employee purchase plan
	+ Buyout own shares (Self tender, target shares repurchase, open market operations
	+ Recapitalization plan
	+ Assume more debt (bonds, loans)
* Pac-Man Defense: Make bid for the hostile bidder
* Litigation: Mostly used to generate delays (not actual defense)
* Corporate Restructuring:
	+ Take corp private
	+ Sell Values Assets
	+ Acquire other companies
	+ Liquidate company

Discriminatory self-Tender: Tender offer initiated by the target or repurchase share from certain shareholders:

* Were put forward as an alternative hostile bid
* Such offer is not illegal
* A company cannot tender for its own shares

# CH 6 – Takeover Tactics

Typical tactics:

Hostile - typically 3 tactics

* Bear Hug: announce intension to tender offer to BoD and threaten to go directly to SH if rejected. Once done, arbitragers typically start accumulating target shares
* Tender Offer: Expensive (need lawyers, brokers)
* Proxy Fight: Tedious

Preliminary steps may include:

* Toehold: Get a toehold position before you go in. Once 5%, have 10 days to report to SEC at which point it becomes public information. Gives 10 days to load up. (Could do casual pass - opposite of a bear hug)
	+ May allow for less expensive purchase
	+ May lower average cost
	+ Discourages white knights and may circumvent supermajority
* Casual Pass: informal overture to target mgmt

Why not max out toeholds:

* Danger of being caught holding share in unsuccessful bid. After discussion dies, share will probably dip below purchase price

Creeping tender offer:

* Open market purchases which can lead to tender offer

2 types of proxy fights:

* Contests for seats on the board
* Contests about management proposals

Increase success of proxy fight: (wakeup call for board members)

* Management has insufficient voting support
* Poor operating performance
* Sound alternative operating plan to improve returns

Arbitrage and M&A

* Risk arbitrage return: RAR + GSS (Gross Stock Spread) / ( Investment \* (365/Investment Period)
* Risks in arbitrage:
* Deal might be cancelled
* Financing environment can change

# Chapter 11 – Corporate Restructuring

* If parent issue, second issue = creates taxable capital gain.
* If offer done from within subsidiary, primary issue therefore no tax consequence, but requires prospectus. If subsidiary does IPO, capital locked up in subsidiary.
	+ Mechanism to roll it up: parent issues debenture to parent, bub rolls up funds by repaying debenture.

Divestitures: Sales of a portion of the firm to a 3rd party. 3 forms:

* Asset Sales: Sale of asset or business division to another company. Raise cash
* Equity Carve-Out: Public offering of a partial interest in a wholly owned subsidiary
	+ Raise cash
	+ By retaining at least 50%the parent can consolidate the businesses for tax purposes.
	+ New legal company created, new shares issues. SH base is different from parent company
	+ Typically followed by a spin-off of remaining shares; Carve-out used to asses market appetite and valuation
	+ Typically 4x more expensive
	+ Pros: Raise $, cons: more expensive than Spin-Off, SEC regulation
* Spin Off: Give equity interest in a subsidiary to existing parent stockholder
	+ Does not raise cash
	+ Subsidiary stock paid as dividend to existing shareholders.
	+ Pros: often tax free, good if restricted access to capital markets
* Bust-Up (Voluntary Liquidation):
	+ When market valuation of assets exceeds stock valuation

Reasons for divestitures:

* Involuntary divestiture:  Justice could request divestiture to comply with antitrust ruling
* Poor strategic fit: funnel cash into core business
* Reverse synergy:
	+ Outside bidder willing to pay more for company than division is worth to parent (issues with inefficiencies, lack of belief in strategic vision, etc…)
* Poor performance:
	+ Rate of return of sub < WACC or patent
	+ Divest to relieve financial drain
* Capital market factors:
	+ Some investors prefer pure plays for portfolio management. Investors prefer doing diversification on their own
	+ Company seems too large for investor
* Cash flow needs
* Abandoning core business

Tracking Stock:

* Create specific class of stock with value based on cash flows of a specific division
* SH have legal interest in earnings of this division, but the division remains part of the overall company unlike a spin-off