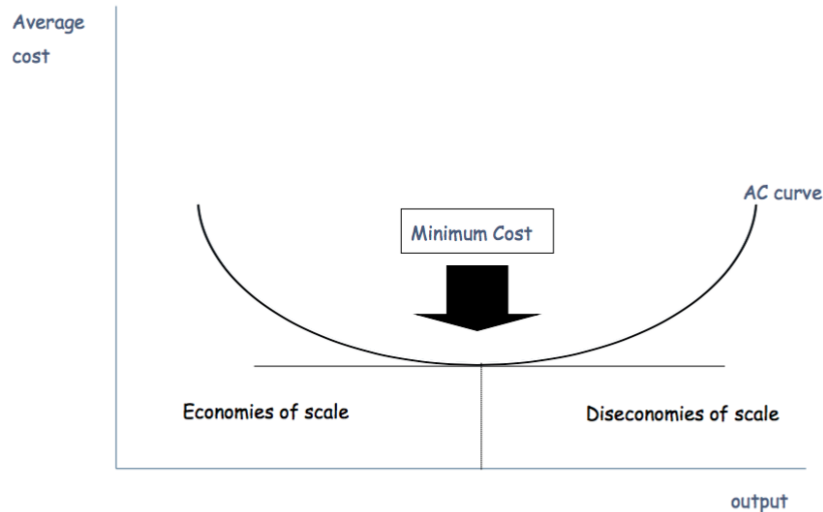
FINC3013 Notes

Module 1

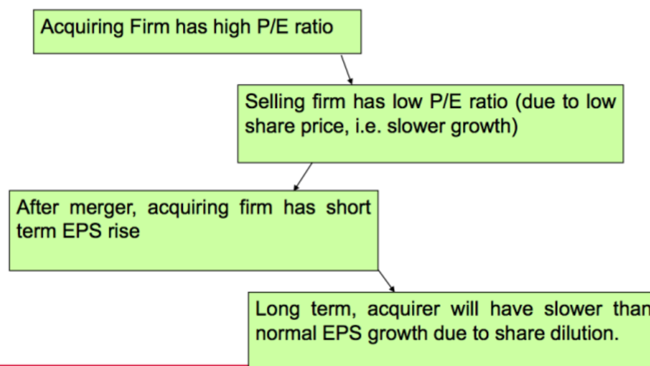
- **Merger**: combination of two corporations in which only one survives, generally a negotiated, friendly deal between equals
- **Tender offer**: offer made directly to a firm's shareholders to buy their shares for a given price, with or without target management's consent
- **Acquisition**: merger or tender offer

Various motives and reasons of conducting M&A

- Economic basis for mergers:
    - Gains from mergers = PV(A+B) – [PV(A) + PV(B)]
    - Do merger if gain greater than costs of merger
    - Costs:
        - Cash payments to target stockholders
        - Securities – may dilute equity
        - Investment banking fees
        - Legal fees
        - Other fees
        - Interest payments on debt
    - NPV = PV(A+B) – [PV(A) + PV(B)] – premium - expenses
- **Growth:**
    - Company may not be able to grow fast enough by internal expansion
        - Internal expansion usually takes more time than acquisition → organic growth
    - Critical issue: <u>premium paid for this speed</u>
        - Does the price of quicker development exceed the price paid for internal development by too much to justify difference
    - Falling stock prices: in periods of falling stock prices, the costs of acquiring assets through purchase of whole companies may justify the acquisition
- **Operating synergies**
    - Scale and scope economics:
        - PV(A+B) > PV(A) + PV(B)
        - Economies of scale: cost savings due to increased output volume; elimination of duplicate facilities; may only last within certain range of output



- **Financial synergies:**
  - Matching of cash-rich firms with growing firms that have investment opportunities
  - Increased debt capacity and tax shields
- **Diversification:**
  - Diversification through merger may create value as it decreases cash flow variability and lowers cost of capital
  - Shareholders can diversify their portfolios much less costly than companies can do this for shareholders
    - Shareholders do not incur the sizeable transaction costs that companies do when they buy other companies
    - Shareholders do not have to pay a premium
  - Diversification to forma lower risk investment for shareholders (coinsurance effect)
  - Diversification to obtain the optimal capital structure
  - Diversification may destroy value due to higher agency costs
- **Increasing earnings per share:**



- **Agency problems:** separation of ownership and control
  - Forms of agency problems: managers prefer less effort and lower risk investment (given low-incentive compensation); substitute low risk for high risk investments (given high-power, convex compensation and limited liabilities); short horizons in decision-making; retain excessive cash reserves (keep leverage too low and dividends too low)

- Free cash flow hypothesis (Jensen 1986): managers are reluctant to pay out cash (to reduce/minimise external capital market monitoring); they engage in negative NPV acquisitions when running out of good ones (to reduce personal undiversified risk and increase the scope of their authority)
  - Empire building (Stulz 1990): If compensation (or private control benefits) is tied to company size, managers have incentives to acquire other firms to increase their size which, in turn, allow them to enjoy higher compensation and benefits
  - Corporate governance solutions for agency problems: board of directors as monitor; large shareholders as monitors; use of debt; executive compensation; input and product markets competition; capital markets as monitors (markets for corporate control → managerial teams compete to run firms, M&As allow more efficient managers to replace less efficient ones, the possibility of a takeover may discipline managers)
- **Hubris hypothesis:** managers may believe their own valuations are superior to the market and cause them to overpay
- **Horizontal mergers:** combinations of two firms producing the same product
  - Main benefits are elimination of duplicate facilities & offer broader product line
- **Vertical merger:**
  - Backward expansion: towards the source of supply
  - Forward expansion: toward the ultimate consumer
- **Desirable characteristics of targets**: low P/E ratio but high book value, firms with undervalued assets, high liquidity, high steady cash flows, unused borrowing capacity, no anti-trust problems, no concentrated block of stock in hands of insiders, management amenable to takeover, overfunded pension plan

Do mergers and acquisitions pay on average?

- **Classes of tests** of M&A profitability:
  - Weak form: $P_{after} > P_{before}$ or Return > 0
  - Semistrong form: $P_{M\&A\ firm} > Return_{benchmark}$
  - Strong form: $Return_{firm\ with\ M\&A} > Return_{firm\ without\ M\&A}$
- **Event studies:** Examine abnormal returns to stockholders around the announcement of a transaction (AR = raw return – market return)
  - Pros: direct measure, forward-looking
  - Cons: strong assumptions about stock markets vulnerable to confounding events
- **Accounting studies:** Examine reported financial results (EPS, ROA etc) of acquirers before and after acquisitions:
  - Pros: credibility (checked by auditors), used by investors
  - Cons: data before and after might be non-comparable, backward-looking, possibly inadequate disclosure, not comparable across companies and countries
- **Surveys of managers:** Ask managers whether M&A creates value
  - Pros: might yield insights unknown by stock market, managers are very familiar with acquisition

    - Cons: might not be focused on economic value, memories of past results can be hazy, typically very low rate of participation
- **Clinical research:** analyse 1 or more transactions in great depth
    - Pros: in-depth analysis of actual experience, ideal for discovering new patterns
    - Cons: ill-suited to hypothesis testing, results often not generalizable
- Summary of event study evidence:
    - Significantly positive abnormal returns for target-buyer combination
    - Significantly positive abnormal returns for target firms
    - Mixed evidence for buyer firms (abnormal returns around zero)