Takeover

LECTURE 8: Analysis of Takeover Part 1

- Acquisition/takeover: purchase of 1 company (target) by another company (acquirer/ bidder). Target shareholders cease to be owners of that firm (smaller company ceases to exist) – hostile.
- Merger: combining 2 entities under common ownership – friendly

1) **Types of takeover**

Horizontal takeover (difficult to classify)	Target and acquirer are in the *same industry* e.g. Facebook & WhatsApp
Vertical takeover (difficult to classify)	Target is either *customer or supplier* of acquirer e.g. Tele Atlas is supplier of TomTom (output of Tele serves as input for TomTom)
Conglomerate takeover (easy to classify)	Target and acquirer operate in *unrelated industries* e.g. Wesfarmers purchase all types of companies from unrelated industries
Friendly takeover	Approved by target's management. Target manager publicly approves and proposes to shareholders.
Hostile takeover	Not approved by target's management. Acquirer goes directly to target shareholders to negotiate (bypass target management) ➔ Often involves takeover defences
Reverse takeover	A private company acquires a public company -> easy to be listed than through an IPO

2) **Reasons for takeover**

Operating synergies (sensible) ⇨ Most popular reason V(AT) > V(A) + V(T)	+ Economies of scale (horizontal takeover): produce a much larger quantity of same outputs -> reduce cost per unit + Economies of scope (vertical): efficient coordination – reduce communication or bargaining cost, quicker processing time + Expertise or complementary resources: cheaper to take over existing assets, experienced staff, customer base. Suitable for horizontal/ vertical takeover. + Replace poor existing management: more suitable for horizontal/vertical takeover since acquirer manager will have similar experience and skills Injecting fresh capital will only increase a target firm's value if the problems are within (internal) the company e.g. poor management team that can be replaced. If the problems lie in the fundamental characteristics of the industry, this reason is not sensible. E.g. rapid obsolescence, intense competition.
Market power (sensible)	+ Acquire a major rival will reduce price competition & increase profit. + However, must negotiate with ACCC to ensure this does not significantly lessen competition level in a particular industry (disadvantage customers or other competitors) + Suitable for horizontal takeover
Tax savings (sensible)	+ Tax advantage if the target company has accumulated tax losses or target company is in a country with lower tax rate + Suitable for acquiring companies who have many foreign investors (shareholders subject to capital tax system)
Diversification (dubious)	+ Diversified portfolio -> diversified firm bears lower risk (eliminate systematic risk) + Not a problem if the other sensible reasons for the takeover exist. HOWEVER, must NOT be the only reason to justify a takeover. + More tax shields due to better debt capacity & lower CF volatility. But benefits do not exceed cost. ⇨ Neither affect the firm's market value nor shareholder wealth
Managerial motives (dubious)	+ Empire building behaviour (agency cost) – controlling a larger company means managers can receive higher salary, larger benefits, more commission opportunities. Manager acts on their own interest which may destroy shareholder wealth. + Overconfidence (hubris hypothesis): CEO may sincerely believe that a merger is in the best interests of the stockholders but that this belief is not rationally based

EPS Bootstrapping (dubious)

+ Even if EPS increases, if no synergy exists, no wealth is created for bidder shareholders
+ EPS will change over a long period of time. Its effect will not be obvious immediately.

Higher growth firm (firm with higher P/E ratio) ***acquires lower growth firm*** to boost EPS and argues it creates value.

	Bidder Ltd	Target Ltd
EPS	$10	$5
P/E ratio	10	4
Share price	$100	$20
Number of shares	200,000	150,000
Earnings	$2,000,000	$750,000
Market capitalization	$20,000,000	$3,000,000

Let's assume that:

- There are no gains from the merger
- The terms of the deal are 1 Bidder share for every 5 Target shares – no premium is paid.

In this case, only pay exactly the amount of Vt and no premium (net cost = 0)

Share price before and after = $100
=> NPV for bidder shareholders = 0

P/E should not stay at $10, but $8.36

Increase in Earnings Per Share (EPS): illustration

$$P/E_{B+T} = \left(P/E_{Bidder} \times \frac{Earnings_{Bidder}}{Earnings_{B+T}}\right) + \left(P/E_{Target} \times \frac{Earnings_{Target}}{Earnings_{B+T}}\right)$$

$$P/E_{Combined} = = \left(10 \times \frac{\$2,000,000}{\$2,750,000}\right) + \left(4 \times \frac{\$750,000}{\$2,750,000}\right) = 8.3636$$

Increase in Earnings Per Share (EPS): illustration

	Bidder Ltd	Target Ltd	Combined
EPS	$10	$5	$11.957
P/E ratio	10	4	8.3636
Share price	$100	$20	$100
Number of shares	200,000	150,000	230,000
Earnings	$2,000,000	$750,000	$2,750,000
Market capitalization	$20,000,000	$3,000,000	$23,000,000

- This is an illustration of what's known as EPS Bootstrapping.

3) **Stylized facts about takeover**

+ Takeover activities in "waves"
  - Peaks of heavy activity followed by quiet troughs
  - Takeover waves often follow economic conditions/ stock market returns. Good market returns => reflect growth in real demand => higher demand can be met via acquisition of additional productive capacity (via market for corporate control – takeover)
  - Each period is dominated by a specific takeover type e.g. 1980s peaks contain mainly hostile takeover. This is because in 1980s, debt is cheaper, and thus it is easier to raise cash. Buyer bypasses target management & directly negotiates with target shareholders.
+ Waves cluster in a relatively small number of industries
  - Takeover is prompted by deregulation, changes in technology, pattern of demand
  - It is likely that if those factors change, takeover will happen in related industries. E.g. economic shock at industry level -> excess capacity -> takeover to liquidate marginal assets.
+ Market reactions to a takeover announcement is often negative
  - **Target shareholders enjoy a gain** (since target shares are often paid at a price over the current market price).
  - **Acquiring shareholders often lose**.
  - **The difference in wealth effects are larger for share bid than cash bid**. – bidder shareholders lose more in share bid (net cost is uncertain).
  - BECAUSE:
    + Market often does not believe the takeover is a good deal (the purchase consideration is huge, and payoff is uncertain) -> *decrease in market price of the acquiring company*.
    + If share bid, *dilute control* since more shares are issued.
    + *Competition* among potential bidders -> raising the final bid
    + Target firm's various *legal and financial counterattacks* (e.g. takeover defences) -> ensure the capitulation is at the highest attainable price -> force bidder to pay more