FINC3013 - Mergers & Acquisitions

Week 1: Introduction to M&A

Lecture: Introduction and Terminology

Identifying the acquirer (bidder) and target (seller)

- A firm that **makes an offer** to purchase another company or an asset is the **bidder** — if they are successful in their purchase, they are an acquirer
  - Objective is to make an offer for the business below intrinsic value so that they can increase their value
  - Managers should act in the best interest of shareholders, seeking to pay the lower price for the firm

- A whole firm **that is acquired**, or the subject of an offer is the **target** — a target may receive an offer just for specific assets
  - Want to sell for the maximum price — achieve the best price for selling their shares
  - Management should act in the best interest of shareholders, seeking to maximise the firm value

- Owners of the company, i.e. the **shareholders decide whether or not to accept an offer** (whom the offer is made to)
  - It is **possible for both companies to get good values**. Owners can get good value from the intrinsic value of the business. The buyer can get good synergy value from combining the two businesses
    - Agency issue: Managers might want to maximise their own wealth rather in the interest of the shareholder, e.g. might lose their own jobs (possibility for agency issues)

Definitions

- **Mergers** are the forms of business transactions where there is a **combination** of two or more companies, and in the process one or more such companies does their corporate existence because the merge with surviving entity
- **Acquisitions** are those forms of business transactions where the shares or **control of a company is taken** over by persons who, prior to the change in shareholding or control, did not possess such shareholding or control
- **Buyouts**: An acquisition where the **acquirer is typically a group of investors**. This is a common term when there is a private equity player involved, e.g. MBO
- **Takeover**: Essentially an acquisition, the term implies a **much larger acquirer** and possibly a level of **hostility** in the deal
- **Reverse takeover:** A typically **smaller, private company is the acquirer** of a larger, listed target. A way to become public without IPO
- **Tax inversion merger**: **Merger** between companies based in **different tax jurisdictions** and resulting in relocating legal HQ to the lower tax area

Classifying deals

- **Horizontal**: Firms in the same industry that compete in the product market
- **Vertical**: Firms at different steps of the production/supply chain process
- **Conglomerate**: Firms not related in industry or in a supply chain (i.e. company in electronics industry goes and buy a car rental company. The firm purchases a range of firms across different industries)
- **Cross-border acquisitions**: Companies from different countries buying each other
- **Financial acquisitions**: Not for business logic, but purchases for financial purposes, e.g. one company has a lot of cash and the the one needs financing

Corporate Strategy

- Buying some other business is known as 'inorganic growth'
- Companies can restructure (partially or totally). They can sell assets, sell part of their business as a division, or have tracking stock — a new stock which tracks part of their business (so investors have a better idea of what is going on in the business)
  - The business can also be sold off, or closed down, etc.

Other important concepts/definitions:

- **Toehold**: Company A buys some shares in Company B. Company A is thinking about launching a bid for Company B, so A buys some shares first to think about whether they should proceed to a formal takeover. **Small stack in company**
  - In Australia, if you own more than 5% of shares in a stock market, you have to tell market participants what you are doing in terms of buying and selling the stock.
  - 20% is important as part of takeover. Once you own more than 20% of the firm, you have to launch a formal bid threshold. Therefore people will try to own below that, before they launch a formal bid.
- **Synergy**: Bidders are willing to pay above the market price**. The value of the combined entity is larger than the value of the company separately**. Strategic rationale.
- **Form of payment**: The way that shareholders are paid. Either cash or stock. There are different outcomes for target shareholders depending how they are paid. If they are paid cash, they move along. If they are paid in shares, then they still have interest in the company
- **Exchange ratio**: If the payment is in the form of stock, then how many shares in the buying company does each shareholder of the target company get? How many shares in the acquiring company is received for each sharer in the target company
- **Competing offers**: One way for management in the target company to maximise value is to convince another company to make a bid
- **Revised bids**: There can be a sequence of offers before the final offer
- **Friendly v Hostile Takeover**: Friendly takeover is a takeover where management is happy with the offer. Hostile take-over means that there is a dispute between bidder and target about sorting out what is going on
- **Merger of Equals**: Two companies of similar size merging
- **Antitrust regulation**: In Australia, it is the competition regulation, to stop making a monopoly. If the ACCC believe that it will reduce competition, then they will oppose the transaction. In USA, that is called the anti-trust regulation.
  - Note: ASIC enforces corporate laws
- **In Play**: A transaction process bid is in process
- **Offer premium**: Generally there is an offer premium. Shareholders have little incentive to sell for current market price.
- **Standalone value**: As a target, you want to understand the standalone value because you want to pay more than that. As a bidder, you want to pay less than the standalone value.
- **Advisers**: You have to think about competition issues, corporate law, valuation, etc. and they involve a lot of advisers. Expert lawyers, accountants, etc.
- **Recommendations**: Board of Directors or Management will look at any bids and make a recommendation to the shareholders of the target firm
- **NewCo**: A merger creating a new company is called a 'NewCo'
- **Due diligence**: Process of finding out about the company that you want to buy is called due diligence. In order to come up with valuation, you need to get information about the business, e.g. profitability, financials, suppliers, customers, etc.
- **Deal terms and conditions**: Once the offer is made there will be T&C. Prices, earn-out, etc.
- **Independent experts report**: Board of Directors of target companies will call in independent experts and write a report on whether the offer is fair and reasonable.
- Compulsory Acquisition: If more than, say, 80% of shareholders approve the sale, then the rest of the shareholders are compelled to sell their stakes

Reading: Akerlof, G. A. (1970). The Market for “Lemons”: Quality Uncertainty and the Market Mechanism. *The Quarterly Journal of Economics*, *84*(3), 488-500.

Overarching Thesis:

- Examines how the quality of goods traded in a market can degrade in the presence of information asymmetry between buyers and sellers, leaving only "lemons" behind
- Get information so you don’t buy a poor company — **importance of due diligence and negotiations**

Explanation

- Uninformed buyer's price creates an adverse selection problem that drives the high-quality cars from the market
  - In this model, as quality is indistinguishable beforehand by the buyer (due to the asymmetry of information), **incentives exist for the seller to pass off low-quality goods as higher-quality ones**.
  - The **buyer, however, takes this incentive into consideration, and takes the quality of the goods to be uncertain**. Only the average quality of the goods will be considered, which in turn will have the side effect that goods that are above average in terms of quality will be driven out of the market.
- Adverse selection is a market mechanism that can lead to a market collapse.

Conditions of a Lemon Market

1. **Asymmetry of information**, in which no buyers can accurately assess the value of a product through examination before sale is made and all sellers can more accurately assess the value of a product prior to sale
2. An **incentive exists for the seller** to pass off a low-quality product as a higher-quality one
3. Sellers have **no credible disclosure technology** (sellers with a great car have no way to disclose this credibly to buyers)
4. Either a **continuum of seller qualities** exists or the average seller type is sufficiently low (buyers are sufficiently pessimistic about the seller's quality)
5. **Deficiency** of effective public quality assurances (by reputation or regulation and/or of effective guarantees/warranties)

Conclusion

- Therefore, owners of good cars will not place their cars on the used car market. The withdrawal of good cars reduces the average quality of cars on the market, causing buyers to revise downward their expectations for any given car. This, in turn, motivates the owners of moderately good cars not to sell, and so on. The result is that a market in which there is asymmetric information with respect to quality shows characteristics similar to those described by Gresham’s Law; the bad drives out the good.
- **Cost of dishonesty on markets**: The cost of dishonesty, therefore, lies not only in the amount by which the purchaser is cheated; the cost **also must include the loss incurred from driving legitimate business out of existence**.

Counteracting Uncertainty

- Brand Names
- Use of guarantees
- Licensing and certifications

Critiques

- Over time the market develops solutions to asymmetric information problem in real life