Mergers

Chapter 32

• Synergy: Value of the whole exceeds sum of the parts. Could arise from:
  – Economies of Scale
  – Operating economies
  – Financial economies
  – Differential management efficiency
  – Taxes (use accumulated losses)

• Break-up value: Assets would be more valuable if broken up and sold to other companies.

Sensible Reasons for Mergers

Economies of Vertical Integration
  – Control over suppliers “may” reduce costs.
  – Over integration can cause the opposite effect.

Pre-integration
  (less efficient)

Company

S S S S

Post-integration
  (more efficient)

Company

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Sensible Reasons for Mergers

Combining Complementary Resources
  Merging may results in each firm filling in the “missing pieces” of their firm with pieces from the other firm.

Firm A

Firm B

Sensible Reasons for Mergers

Mergers as a Use for Surplus Funds
  If your firm is in a mature industry with few, if any, positive NPV projects available, acquisition may be the best use of your funds.

Bank of America Family Tree

Note: Ironically, MBNA was once owned by a previous version of Bank of America, which sold it in an IPO.
Diversification
- Investors should not pay a premium for diversification since they can do it themselves

Purchase of assets at below replacement cost

Acquire other firms to increase size, thus making it more difficult to be acquired

Dubious Reasons for Mergers

The Bootstrap Game

- Acquiring Firm has high P/E ratio
- Selling firm has low P/E ratio (due to low number of shares)
- After merger, acquiring firm has short term EPS rise
- Long term, acquirer will have slower than normal EPS growth due to share dilution.

Estimating Merger Gains

- Friendly merger:
  - The merger is supported by the managements of both firms.
- Hostile merger:
  - Target firm’s management resists the merger.
  - Acquirer must go directly to the target firm’s stockholders, try to get 51% to tender their shares.
  - Often, mergers that start out hostile end up as friendly, when offer price is raised.

Estimating Merger Gains

\[ \text{Gain} = PV_{AB} - (PV_A + PV_B) = \Delta PV_{AB} \]

\[ \text{Cost} = \text{Cash paid} - PV_B \]

\[ \text{NPV} = \text{gain} - \text{lost} = \Delta PV_{AB} - (\text{cash} - PV_B) \]

Estimating Merger Gains

- Questions
  - Is there an overall economic gain to the merger?
  - Do the terms of the merger make the company and its shareholders better off?

\[ PV(AB) > PV(A) + PV(B) \]
Takeover Methods

**Tools Used To Acquire Companies**

- Proxy Contest
- Acquisition
- Leveraged Buy-Out
- Management Buy-Out
- Tender Offer
- Merger

**Takeover Defenses**

**White Knight** - Friendly potential acquirer sought by a target company threatened by an unwelcome suitor.

**Shark Repellent** - Amendments to a company charter made to forestall takeover attempts.

**Poison Pill** - Measure taken by a target firm to avoid acquisition; for example, the right for existing shareholders to buy additional shares at an attractive price if a bidder acquires a large holding.

Do mergers really create value?

- According to empirical evidence, acquisitions do create value as a result of economies of scale, other synergies, and/or better management.
- Shareholders of target firms reap most of the benefits, that is, the final price is close to full value.
  - Target management can always say no.
  - Competing bidders often push up prices.