Mergers and Acquisitions Basics
All You Need To Know

Donald DePamphilis
MERGERS AND ACQUISITIONS BASICS
WHY WE NEED TO UNDERSTAND THE ROLE OF MERGERS AND ACQUISITIONS IN TODAY’S WORLD

Mergers, acquisitions, business alliances, and corporate restructuring activities are increasingly commonplace in both developed and emerging economies. Given the frequency with which such activities occur, it is critical for business people and officials at all levels of government to have a basic understanding of why and how they take place and how they can affect economic growth. A lack of understanding of the role mergers and acquisitions (M&As) play in a modern economy can mean the failure to use such transactions as an effective means of implementing a business strategy. Moreover, ignorance can lead to overregulation of what are important means of disciplining incompetent managers and transferring ownership of operating assets to those who can utilize them most efficiently.

This book seeks to bring clarity to what is a complex, sometimes frustrating, and ultimately exciting subject. It presents an integrated way to think about the myriad activities involved in mergers and acquisitions. Although various types of business alliances and aspects of corporate restructuring are addressed in brief, the primary focus is on M&As.

The Book’s Unique Features

This book is unique among books of this type in several specific ways. First, it is aimed primarily at practitioners who need a quick overview of the subject without getting bogged down in minutiae. Rather than provide intensive coverage of every aspect of mergers and acquisitions, as might be found in a comprehensive textbook, or “dumb down” the subject matter to provide only superficial—and perhaps inaccurate or misleading explanations—the text occupies a middle ground. No significant knowledge of finance, economics, or accounting is required, although a passing acquaintance with these disciplines is helpful. While reader-friendly, the text also draws on academic studies to substantiate key observations and conclusions that are empirically based. Details of these studies are often found in chapter footnotes.

Each chapter concludes with a section called “A Case in Point” that illustrates the chapter material with a real-world example. These sections include thought-provoking questions that encourage you, the reader, to apply the concepts explored in the chapter.
Who Should Read This Book

This book is aimed at buyers and sellers of businesses, financial analysts, chief executive officers, chief financial officers, operating managers, investment bankers, and portfolio managers. Others who may have an interest include bank lending officers, venture capitalists, government regulators, human resource managers, entrepreneurs, and board members. In addition, the book may be used as a companion or supplemental text for undergraduate and graduate students in courses on mergers and acquisitions, corporate restructuring, business strategy, management, governance, and entrepreneurship. Supplemented with newspaper and magazine articles, the book could serve as the primary text in an introductory course on mergers and acquisitions.

For a more rigorous and detailed discussion on mergers and acquisitions and other forms of corporate restructuring, the reader may wish to see the author’s textbook on the subject, *Mergers, Acquisitions, and Other Restructuring Activities*. The 5th edition (2009) is published by Academic Press. The reader also may be interested in the author’s *Mergers and Acquisitions Basics: Negotiation and Deal Structuring*, also published by Academic Press in 2010.
I would like to express my sincere appreciation for the many resources of Academic Press/Butterworth-Heinemann/Elsevier in general and for the ongoing support provided by Karen Maloney, Managing Editor, and J. Scott Bentley, Executive Editor, as well as Scott M. Cooper, who helped streamline this manuscript for its primary audience. Finally, I would like to thank Alan Cherry, Ross Bengel, Patricia Douglas, Jim Healy, Charles Higgins, Michael Lovelady, John Mellen, Jon Saxon, David Offenberg, Chris Manning, and Maria Quijada for their many constructive comments.
CHAPTER 1

Introduction to Mergers and Acquisitions

The first decade of the new millennium heralded an era of global mega-mergers. Like the mergers and acquisitions (M&As) frenzy of the 1980s and 1990s, several factors fueled activity through mid-2007: readily available credit, historically low interest rates, rising equity markets, technological change, global competition, and industry consolidation. In terms of dollar volume, M&A transactions reached a record level worldwide in 2007. But extended turbulence in the global credit markets soon followed.

The speculative housing bubble in the United States and elsewhere, largely financed by debt, burst during the second half of the year. Banks, concerned about the value of many of their own assets, became exceedingly selective and largely withdrew from financing the highly leveraged transactions that had become commonplace the previous year. The quality of assets held by banks throughout Europe and Asia also became suspect, reflecting the global nature of the credit markets. As credit dried up, a malaise spread worldwide in the market for highly leveraged M&A transactions.

By 2008, a combination of record high oil prices and a reduced availability of credit sent most of the world’s economies into recession, reducing global M&A activity by more than one-third from its previous high. This global recession deepened during the first half of 2009—despite a dramatic drop in energy prices and highly stimulative monetary and fiscal policies—extending the slump in M&A activity.

In recent years, governments worldwide have intervened aggressively in global credit markets (as well as in manufacturing and other sectors of the economy) in an effort to restore business and consumer confidence, restore credit market functioning, and offset deflationary pressures. What impact have such actions had on mergers and acquisitions? It is too early to tell, but the implications may be significant.

M&As are an important means of transferring resources to where they are most needed and of removing underperforming managers. Government decisions to save some firms while allowing others to fail are likely to disrupt this process. Such decisions are often based on the notion that some
firms are simply too big to fail because of their potential impact on the economy—consider AIG in the United States. Others are clearly motivated by politics. Such actions disrupt the smooth functioning of markets, which rewards good decisions and penalizes poor ones. Allowing a business to believe that it can achieve a size “too big to fail” may create perverse incentives. Plus, there is very little historical evidence that governments are better than markets at deciding who should fail and who should survive.

In this chapter, you will gain an understanding of the underlying dynamics of M&As in the context of an increasingly interconnected world. The chapter begins with a discussion of M&As as change agents in the context of corporate restructuring. The focus is on M&As and why they happen, with brief consideration given to alternative ways of increasing shareholder value. You will also be introduced to a variety of legal structures and strategies that are employed to restructure corporations.

Throughout this book, a firm that attempts to acquire or merge with another company is called an **acquiring company**, **acquirer**, or **bidder**. The **target company** or **target** is the firm being solicited by the acquirer. **Takeovers** or **buyouts** are generic terms for a change in the controlling ownership interest of a corporation.

Words in **bold italics** are the ones most important for you to understand fully; they are all included in a glossary at the end of the book.

**MERGERS AND ACQUISITIONS AS CHANGE AGENTS**

Businesses come and go in a continuing churn, perhaps best illustrated by the ever-changing composition of the so-called Fortune 500—the 500 largest U.S. corporations. Only 70 of the firms on the original 1955 list of 500 are on today’s list, and some 2,000 firms have appeared on the list at one time or another. Most have dropped off the list either through merger, acquisition, bankruptcy, downsizing, or some other form of corporate restructuring. Consider a few examples: Chrysler, Bethlehem Steel, Scott Paper, Zenith, Rubbermaid, Warner Lambert. The popular media tends to use the term **corporate restructuring** to describe actions taken to expand or contract a firm’s basic operations or fundamentally change its asset or financial structure.¹

¹ The broad array of activities falling under this catchall term runs the gamut from reorganizing business units to takeovers and joint ventures to divestitures and spin-offs and equity carve-outs. A detailed discussion of these alternative forms of restructuring is beyond the scope of this book. To learn more, see *Mergers, Acquisitions, and other Restructuring Activities* by Donald M. DePamphilis, now in its fifth edition and available through Academic Press.
WHY MERGERS AND ACQUISITIONS HAPPEN

The prevalence of M&As and the importance of various factors that give rise to M&A activity varies over time. Exhibit 1-1 lists some of the more prominent theories about why M&As happen, each of which is discussed in greater detail in the following sections.

<table>
<thead>
<tr>
<th>Theory</th>
<th>Motivation</th>
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<tbody>
<tr>
<td>Operating Synergy</td>
<td>Improve operating efficiency through economies of scale or scope by acquiring a customer, supplier, or competitor</td>
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<tr>
<td>Economies of Scale</td>
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<td>Economies of Scope</td>
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<tr>
<td>Financial Synergy</td>
<td>Lower cost of capital</td>
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<tr>
<td>Diversification</td>
<td>Position the firm in higher growth products or markets</td>
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<td>New Products/Current Markets</td>
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<td>Current Products/New Markets</td>
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<tr>
<td>Strategic Realignment</td>
<td>Acquire capabilities to adapt more rapidly to environmental changes than could be achieved if they were developed internally</td>
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<td>Technological Change</td>
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<td>Regulatory and Political Change</td>
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<tr>
<td>Hubris (Managerial Pride)</td>
<td>Acquirers believe their valuation of target more accurate than the market's, causing them to overpay by overestimating synergy</td>
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<tr>
<td>Buying Undervalued Assets (Q-Ratio)</td>
<td>Acquire assets more cheaply when the equity of existing companies is less than the cost of buying or building the assets</td>
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<tr>
<td>Mismanagement (Agency Problems)</td>
<td>Replace managers not acting in the best interests of the owners</td>
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<td>Managerialism</td>
<td>Increase the size of a company to increase the power and pay of managers</td>
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<td>Tax Considerations</td>
<td>Obtain unused net operating losses and tax credits, asset write-ups, and substitute capital gains for ordinary income</td>
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<tr>
<td>Market Power</td>
<td>Increase market share to improve ability to set prices above competitive levels</td>
</tr>
<tr>
<td>Misvaluation</td>
<td>Investor overvaluation of acquirer’s stock encourages M&amp;As</td>
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Synergy

Synergy is the rather simplistic notion that two (or more) businesses in combination will create greater shareholder value than if they are operated separately. It may be measured as the incremental cash flow that can be realized through combination in excess of what would be realized were the firms to remain separate. There are two basic types of synergy: operating and financial.

Operating Synergy (Economies of Scale and Scope)

Operating synergy comprises both economies of scale and economies of scope, which can be important determinants of shareholder wealth creation.² Gains in efficiency can come from either factor and from improved managerial practices.

Spreading fixed costs over increasing production levels realizes economies of scale, with scale defined by such fixed costs as depreciation of equipment and amortization of capitalized software; normal maintenance spending; obligations such as interest expense, lease payments, and long-term union, customer, and vendor contracts; and taxes. These costs are fixed in that they cannot be altered in the short run. By contrast, variable costs are those that change with output levels. Consequently, for a given scale or amount of fixed expenses, the dollar value of fixed expenses per unit of output and per dollar of revenue decreases as output and sales increase.

To illustrate the potential profit improvement from economies of scale, let’s consider an automobile plant that can assemble 10 cars per hour and runs around the clock—which means the plant produces 240 cars per day. The plant’s fixed expenses per day are $1 million, so the average fixed cost per car produced is $4,167 (i.e., $1,000,000/240). Now imagine an improved assembly line that allows the plant to assemble 20 cars per hour, or 480 per day. The average fixed cost per car per day falls to $2,083 (i.e., $1,000,000/480). If variable costs (e.g., direct labor) per car do not increase, and the selling price per car remains the same for each car, the profit improvement per car due to the decline in average fixed costs per car per day is $2,084 (i.e., $4,167 – $2,083).

A firm with high fixed costs as a percentage of total costs will have greater earnings variability than one with a lower ratio of fixed to total costs. Let’s consider two firms with annual revenues of $1 billion and operating profits of $50 million. The fixed costs at the first firm represent 100 percent of total costs, but at the second fixed costs are only half of all costs. If revenues at both firms increased by $50 million, the first firm would see

² DeLong (2003); Houston, James, and Ryngaert (2001).
income increase to $100 million, precisely because all of its costs are fixed. Income at the second firm would rise only to $75 million, because half of the $50 million increased revenue would have to go to pay for increased variable costs.

Using a specific set of skills or an asset currently employed to produce a given product or service to produce something else realizes *economies of scope*, which are found most often when it is cheaper to combine multiple product lines in one firm than to produce them in separate firms. Procter & Gamble, the consumer products giant, uses its highly regarded consumer marketing skills to sell a full range of personal care as well as pharmaceutical products. Honda knows how to enhance internal combustion engines, so in addition to cars, the firm develops motorcycles, lawn mowers, and snow blowers. Sequent Technology lets customers run applications on UNIX and NT operating systems on a single computer system. Citigroup uses the same computer center to process loan applications, deposits, trust services, and mutual fund accounts for its bank’s customers. Each is an example of economies of scope, where a firm is applying a specific set of skills or assets to produce or sell multiple products, thus generating more revenue.

**Financial Synergy (Lowering the Cost of Capital)**

*Financial synergy* refers to the impact of mergers and acquisitions on the cost of capital of the acquiring firm or newly formed firm resulting from a merger or acquisition. The cost of capital is the minimum return required by investors and lenders to induce them to buy a firm’s stock or to lend to the firm.

In theory, the cost of capital could be reduced if the merged firms have cash flows that do not move up and down in tandem (i.e., so-called co-insurance), realize financial economies of scale from lower securities issuance and transactions costs, or result in a better matching of investment opportunities with internally generated funds. Combining a firm that has excess cash flows with one whose internally generated cash flow is insufficient to fund its investment opportunities may also result in a lower cost of borrowing. A firm in a mature industry experiencing slowing growth may produce cash flows well in excess of available investment opportunities. Another firm in a high-growth industry may not have enough cash to realize its investment opportunities. Reflecting their different growth rates and risk levels, the firm in the mature industry may have a lower cost of capital than the one in the high-growth industry, and combining the two firms could lower the average cost of capital of the combined firms.
Diversification

Buying firms outside a company’s current primary lines of business is called *diversification*, and is typically justified in one of two ways. Diversification may create financial synergy that reduces the cost of capital, or it may allow a firm to shift its core product lines or markets into ones that have higher growth prospects, even ones that are unrelated to the firm’s current products or markets. The extent to which diversification is unrelated to an acquirer’s current lines of business can have significant implications for how effective management is in operating the combined firms.

Exhibit 1-2 is a product–market matrix that identifies a firm’s primary diversification options. A firm facing slower growth in its current markets may be able to accelerate growth through related diversification by selling its current products in new markets that are somewhat unfamiliar and, therefore, more risky. Such was the case when pharmaceutical giant Johnson & Johnson announced its ultimately unsuccessful takeover attempt of Guidant Corporation in late 2004. J&J was seeking an entry point for its medical devices business in the fast-growing market for implantable devices, in which it did not then participate. A firm may attempt to achieve higher growth rates by developing or acquiring new products with which it is relatively unfamiliar and then selling them in familiar and less risky current markets. Retailer JCPenney’s acquisition of the Eckerd Drugstore chain or J&J’s $16 billion acquisition of Pfizer’s consumer healthcare products line in 2006 are two examples of related diversification. In each instance, the firm assumed additional risk, but less so than unrelated diversification if it had developed new products for sale in new markets. There is considerable evidence that investors do not benefit from unrelated diversification.

Firms that operate in a number of largely unrelated industries, such as General Electric, are called *conglomerates*. The share prices of conglomerates

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### Exhibit 1-2. Product–Market Matrix

<table>
<thead>
<tr>
<th>Products</th>
<th>Markets</th>
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<tr>
<td>Current</td>
<td>Lower Growth/Lower Risk</td>
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<tr>
<td>New</td>
<td>Higher Growth/Higher Risk (Related Diversification)</td>
<td>Highest Growth/Highest Risk (Unrelated Diversification)</td>
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</table>
often trade at a discount—as much as 10 to 15 percent—compared to shares of focused firms or to their value were they broken up. This discount is called the conglomerate discount or diversification discount. Investors often perceive companies diversified in unrelated areas (i.e., those in different standard industrial classifications) as riskier because management has difficulty understanding these companies and often fails to provide full funding for the most attractive investment opportunities. Moreover, outside investors may have a difficult time understanding how to value the various parts of highly diversified businesses. Researchers differ on whether the conglomerate discount is overstated.

Still, although the evidence suggests that firms pursuing a more focused corporate strategy are likely to perform best, there are always exceptions.

**Strategic Realignment**

The strategic realignment theory suggests that firms use M&As to make rapid adjustments to changes in their external environments. Although change can come from many different sources, this theory considers only changes in the regulatory environment and technological innovation—two factors that, over the past 20 years, have been major forces in creating new opportunities for growth, and threatening, or making obsolete, firms’ primary lines of business.

**Regulatory Change**

Those industries that have been subject to significant deregulation in recent years—financial services, health care, utilities, media, telecommunications,

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5 Best and Hodges (2004).
6 Some argue that diversifying firms are often poor performers before they become conglomerates (Camp and Simi, 2002; Hyland, 2001), whereas others conclude that the conglomerate discount is a result of how the sample studied is constructed (Graham, Lemmon, and Wolf, 2002; Villalonga, 2004). Several suggest that the conglomerate discount is reduced when firms either divest or spin off businesses in an effort to achieve greater focus on the core business portfolio (Dittmar and Shivdasani, 2003; Shin and Stulz, 1998). Still others find evidence that the most successful mergers are those that focus on deals that promote the acquirer’s core business (Harding and Rovit, 2004; Megginson et al., 2003). Related acquisitions may even be more likely to experience higher financial returns than unrelated acquisitions (Singh and Montgomery, 2008). This should not be surprising in that related firms are more likely to be able to realize cost savings due to overlapping functions and product lines than are unrelated firms. There is even an argument that diversified firms in developing countries, where access to capital markets is limited, may sell at a premium to more focused firms (Fauver, Houston, and Narrango, 2003). Under these circumstances, corporate diversification may enable more efficient investment because diversified firms may use cash generated by mature subsidiaries to fund those with higher growth potential.
defense—have been at the center of M&A activity because deregulation breaks down artificial barriers and stimulates competition. During the first half of the 1990s, for instance, the U.S. Department of Defense actively encouraged consolidation of the nation’s major defense contractors to improve their overall operating efficiency.

Utilities now required in some states to sell power to competitors that can resell the power in the utility’s own marketplace respond with M&As to achieve greater operating efficiency. Commercial banks that have moved beyond their historical role of accepting deposits and granting loans are merging with securities firms and insurance companies thanks to the Financial Services Modernization Act of 1999, which repealed legislation dating back to the Great Depression. The Citicorp–Travelers merger a year earlier anticipated this change, and it is probable that their representatives were lobbying for the new legislation. The final chapter has yet to be written: this trend toward huge financial services companies may yet be stymied by new regulation passed in 2010 in response to excessive risk taking.

The telecommunications industry offers a striking illustration. Historically, local and long-distance phone companies were not allowed to compete against each other, and cable companies were essentially monopolies. Since the Telecommunications Act of 1996, local and long-distance companies are actively encouraged to compete in each other’s markets, and cable companies are offering both Internet access and local telephone service. When a federal appeals court in 2002 struck down a Federal Communications Commission regulation prohibiting a company from owning a cable television system and a broadcast TV station in the same city, and threw out the rule that barred a company from owning TV stations that reach more than 35 percent of U.S. households, it encouraged new combinations among the largest media companies or purchases of smaller broadcasters.

**Technological Change**

Technological advances create new products and industries. The development of the airplane created the passenger airline, avionics, and satellite industries. The emergence of satellite delivery of cable networks to regional and local stations ignited explosive growth in the cable industry. Today, with the expansion of broadband technology, we are witnessing the convergence of voice, data, and video technologies on the Internet. The emergence of digital camera technology has reduced dramatically the demand for analog

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7 Mitchell and Mulherin (1996); Mulherin and Boone (2000).
cameras and film and sent household names such as Kodak and Polaroid scrambling to adapt. The growth of satellite radio is increasing its share of the radio advertising market at the expense of traditional radio stations.

Smaller, more nimble players exhibit speed and creativity many larger, more bureaucratic firms cannot achieve. With engineering talent often in short supply and product life cycles shortening, these larger firms may not have the luxury of time or the resources to innovate. So, they may look to M&As as a fast and sometimes less expensive way to acquire new technologies and proprietary know-how to fill gaps in their current product portfolios or to enter entirely new businesses. Acquiring technologies can also be a defensive weapon to keep important new technologies out of the hands of competitors. In 2006, eBay acquired Skype Technologies, the Internet phone provider, for $3.1 billion in cash, stock, and performance payments, hoping that the move would boost trading on its online auction site and limit competitors’ access to the new technology. By September 2009, eBay had to admit that it had been unable to realize the benefits of owning Skype and was selling the business to a private investor group for $2.75 billion.

**Hubris and the “Winner’s Curse”**

Managers sometimes believe that their own valuation of a target firm is superior to the market’s valuation. Thus, the acquiring company tends to overpay for the target, having been overoptimistic when evaluating synergies. Competition among bidders also is likely to result in the winner overpaying because of hubris, even if significant synergies are present. In an auction environment with bidders, the range of bids for a target company is likely to be quite wide, because senior managers tend to be very competitive and sometimes self-important. Their desire not to lose can drive the purchase price of an acquisition well in excess of its actual economic value (i.e., cash-generating capability). The winner pays more than the company is worth and may ultimately feel remorse at having done so—hence what has come to be called the winner’s curse.

**Buying Undervalued Assets (The Q-Ratio)**

The q-ratio is the ratio of the market value of the acquiring firm’s stock to the replacement cost of its assets. Firms interested in expansion can choose to invest in new plants and equipment or obtain the assets by acquiring a

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8 Roll (1986).
company with a market value less than what it would cost to replace the assets (i.e., q-ratio < 1). This theory was very useful in explaining M&A activity during the 1970s, when high inflation and interest rates depressed stock prices well below the book value of many firms. High inflation also caused the replacement cost of assets to be much higher than the book value of assets. Book value refers to the value of assets listed on a firm’s balance sheet and generally reflects the historical cost of acquiring such assets rather than their current cost.

When gasoline refiner Valero Energy Corp. acquired Premcor Inc. in 2005, the $8 billion transaction created the largest refiner in North America. It would have cost an estimated 40 percent more for Valero to build a new refinery with equivalent capacity.⁹

**Mismanagement (Agency Problems)**

*Agency problems* arise when there is a difference between the interests of incumbent managers (i.e., those currently managing the firm) and the firm’s shareholders. This happens when management owns a small fraction of the outstanding shares of the firm. These managers, who serve as agents of the shareholder, may be more inclined to focus on their own job security and lavish lifestyles than on maximizing shareholder value. When the shares of a company are widely held, the cost of such mismanagement is spread across a large number of shareholders, each of whom bears only a small portion. This allows for tolerance of the mismanagement over long periods. Mergers often take place to correct situations in which there is a separation between what managers and owners (shareholders) want. Low stock prices put pressure on managers to take actions to raise the share price or become the target of acquirers, who perceive the stock to be undervalued¹⁰ and who are usually intent on removing the underperforming management of the target firm.

Agency problems also contribute to management-initiated buyouts, particularly when managers and shareholders disagree over how excess cash flow should be used.¹¹ Managers may have access to information not readily available to shareholders and may therefore be able to convince lenders to provide funds to buy out shareholders and concentrate ownership in the hands of management.

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¹⁰ Fama and Jensen (1983).
Managerialism

The *managerialism theory* for acquisitions asserts that managers make acquisitions for selfish reasons, whether to add to their prestige, build their spheres of influence, augment their compensation, or for self-preservation. But ascribing acquisition to the managerialism motive ignores the pressure managers of larger firms are under to sustain earnings growth to support their firms’ share price. As the market value of a firm increases, senior managers are compelled to make ever larger investment bets to sustain increases in shareholder value. Small acquisitions simply do not have sufficient impact on earnings growth to justify the effort required to complete them. Consequently, even though the resulting acquisitions may destroy value, the motive for making them may be more to support shareholder interests than to preserve management autonomy.

Tax Considerations

Tax benefits, such as loss carry forwards and investment tax credits, can be used to offset the taxable income of firms that combine through M&As. Acquirers of firms with accumulated losses may use them to offset future profits generated by the combined firms. Unused tax credits held by target firms may also be used to lower future tax liabilities. Additional tax shelter (i.e., tax savings) is created due to the purchase method of accounting, which requires the book value of the acquired assets to be revalued to their current market value for purposes of recording the acquisition on the books of the acquiring firm. The resulting depreciation of these generally higher asset values also reduces the amount of future taxable income generated by the combined companies as depreciation expense is deducted from revenue in calculating a firm’s taxable income.

The taxable nature of the transaction often plays a more important role in determining whether a merger takes place than any tax benefits that accrue to the acquiring company. The seller may view the tax–free status of the transaction as a prerequisite for the deal to take place. A properly structured transaction can allow the target shareholders to defer any capital gain resulting from the transaction until they actually sell the acquirer’s stock received in exchange for their shares. If the transaction is not tax free, the seller typically will want a higher purchase price to compensate for the tax liability resulting from the transaction.

12 Groton et al. (2007); Masulis, Wang, and Xie (2007).
Market Power

The theory of market power suggests that firms merge to improve their monopoly power to set product prices at levels not sustainable in a more competitive market. However, there is little evidence that this is true, despite how often the popular press publishes it as the reason mergers should not be allowed. In fact, increased merger activity is much more likely to contribute to improved operating efficiency of the combined firms than to increased market power, as you will learn later in this chapter.

Misvaluation

The presumption that markets are efficient implies that a target’s share price reflects accurately all information about the firm and therefore its true economic value (i.e., potential for generating cash). When important information is not widely known about a firm, however, investors may over- or undervalue the firm. There is substantial evidence of a disconnect, however: over time, asset values do, indeed, reflect their true economic value, but at specific moments they may not.

Some suggest that acquirers can periodically profit by buying undervalued targets for cash at a price below their actual value or by using equity (even if the target is overvalued), so long as the target is less overvalued than the bidding firm’s stock. Overvalued shares enable the acquirer to purchase a target firm in a share-for-share exchange by issuing fewer shares, which reduces the probability of diluting the ownership position of current acquirer shareholders in the newly combined company. That’s important because dilution represents a significant cost to the current shareholders of the acquiring firm; their shares represent claims on the firm’s earnings, cash flows, assets, and liabilities.

Whenever a firm increases its shares outstanding, it reduces the proportionate ownership position of current shareholders. Overvalued shares tend to reduce this cost. Consider an acquirer who offers the target firm shareholders $10 for each share they own. The acquirer’s current share price is $10. The acquirer would have to issue one new share for each target share outstanding. If the acquirer’s share price is valued at $20, only 0.5 new shares would have to be issued, and so forth. Consequently, the initial dilution of the ownership position of current acquirer shareholders in the new firm is less the higher the acquirer’s share price compared to the price offered for each share of target stock outstanding.

14 Ang and Cheng (2006); Dong et al. (2006).
ALTERNATIVE FORMS OF CORPORATE RESTRUCTURING

Corporate restructuring activities are often broken into two specific categories. **Operational restructuring** typically refers to the outright or partial sale of companies or product lines or to downsizing by closing unprofitable or nonstrategic facilities. **Financial restructuring** describes actions by a firm to change its total debt and equity structure, such as share repurchases or adding debt either to lower the corporation’s overall cost of capital or as part of an antitakeover defense (discussed in more detail in Chapter 3). The relative proportions of debt and equity held by a firm are the firm’s capital structure.

Mergers and Consolidations

Mergers can be described from a legal and an economic perspective—a distinction important to discussions of deal structuring, regulation, and strategic planning.

*A Legal Perspective*

The legal structures may take on many forms depending on the nature of a transaction. A **merger** is a combination of two or more firms in which all but one cease to exist *legally*; the combined organization continues under the original name of the surviving firm. In a typical merger, shareholders of the target firm—after voting to approve the merger—exchange their shares for those of the acquiring firm. Those not voting in favor (minority shareholders) are required to accept the merger and exchange their shares for those of the acquirer.

There are several different types of mergers. If a merger involves the subsidiary of a parent firm but not the parent, and the parent is the primary shareholder in the subsidiary, the merger does not require approval of the parent’s shareholders (at least in most U.S. states). Such a merger is called a short form merger. The principal requirement is that the parent’s ownership exceeds the minimum threshold set by the state. For example, Delaware allows a parent corporation to merge with a subsidiary without a shareholder vote if the parent owns at least 90 percent of the outstanding voting shares.

A **statutory merger** is one in which the acquiring company assumes the assets and liabilities of the target in accordance with the statutes of the state in which the combined companies will be incorporated. A **subsidiary merger** involves the target becoming a subsidiary of the parent. To the public, the target firm may be operated under its brand name, but it will be owned and controlled by the acquirer.
Although the terms *merger* and *consolidation* often are used interchangeably, a *statutory consolidation*—which involves two or more companies joining to form a new company—is technically not a merger. All legal entities that are consolidated are dissolved during the formation of the new company, which usually has a new name. In a merger, either the acquirer or the target survives. The 1999 combination of Daimler-Benz and Chrysler to form DaimlerChrysler is an example of a consolidation. The new corporate entity created as a result of consolidation or the surviving entity following a merger usually assumes ownership of the assets and liabilities of the merged or consolidated organizations. Stockholders in consolidated companies typically exchange their shares for shares in the new company.

A *merger of equals* is a merger framework usually applied whenever the merger participants are comparable in size, competitive position, profitability, and market capitalization (i.e., the total value of a firm’s shares), and so it is unclear whether one party is ceding control to another and which party is providing the greatest synergy. It is typical for the CEOs of the merged firms to become co-equal managers of the new firm and for the new firm’s board of directors to have equal representation from the boards of the merged firms. Target firm shareholders rarely receive any significant premium for their shares in a merger of equals.\(^\text{15}\) It is quite uncommon for the ownership split to be equally divided.\(^\text{16}\) The 1998 formation of Citigroup from Citibank and Travelers is an example of a merger of equals.

**An Economic Perspective**

Business combinations may also be defined depending on whether the merging firms are in the same or different industries and on their positions in the corporate value chain.\(^\text{17}\) These definitions are particularly important for antitrust analysis.

A *horizontal merger* occurs between two firms within the same industry; Procter & Gamble and Gillette (2006) in household products, Oracle and PeopleSoft (2004) in business application software, oil giants Exxon and Mobil (1999), SBC Communications and Ameritech (1998) in telecommunications, and NationsBank and BankAmerica (1998) in commercial banking are all examples. A *conglomerate merger* is one in which the

\(^\text{15}\) Wulf (2004) suggested that the CEOs of target firms often negotiate to retain a significant degree of control in the merged firm for both their board and management in exchange for a lower premium for their shareholders.

\(^\text{16}\) According to Mallea (2008), only 14 percent have a 50/50 split.

\(^\text{17}\) Porter (1985).
acquiring company purchases a firm in a largely unrelated industry, such as the mid-1980s acquisition by U.S. Steel of Marathon Oil to form USX.

*Vertical mergers* involve firms that participate at different stages of the production or value chain (see Exhibit 1–3). A simple value chain in the basic steel industry may distinguish between raw materials, such as coal or iron ore; steel making, such as “hot metal” and rolling operations; and metals distribution. Similarly, a value chain in the oil and gas industry would separate exploration activities from production, refining, and marketing. An Internet value chain might distinguish between infrastructure providers such as Cisco, content providers such as Dow Jones, and portals such as Yahoo! and Google. In a vertical merger, companies that do not own operations in each major segment of the value chain “backward integrate” by acquiring a supplier or “forward integrate” by acquiring a distributor. When paper manufacturer Boise Cascade acquired OfficeMax, an office products distributor, in 2003, the $1.1 billion transaction was forward integration. America Online’s purchase of media and content provider Time Warner in 2000 is an example of backward integration.\(^\text{18}\)

### Acquisitions, Divestitures, Spinoffs, Carve-Outs, and Buyouts

Generally speaking, an *acquisition* occurs when one company takes a controlling ownership interest in another firm, a legal subsidiary of another firm, or selected assets (e.g., a manufacturing facility) of another firm. An acquisition may involve the purchase of another firm’s assets or stock, with the acquired firm continuing to exist as a legally owned subsidiary. In contrast,

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\(^{18}\) According to Gugler, Mueller, Yurtoglu, and Zulehner (2003), horizontal, conglomerate, and vertical mergers accounted for 42 percent, 54 percent, and 4 percent, respectively, of the 45,000 transactions analyzed between 1981 and 1998.
a divestiture is the sale of all or substantially all of a company or product line to another party for cash or securities. In a spinoff, a parent creates a new legal subsidiary and distributes shares in the subsidiary to its current shareholders as a stock dividend. An equity carve-out describes a transaction in which the parent firm issues a portion of its stock or that of a subsidiary to the public.

A leveraged buyout (LBO) or highly leveraged transaction involves the purchase of a company financed primarily by debt. Although LBOs typically involve privately owned firms, the term often is applied when a firm buys back its stock using primarily borrowed funds to convert from a publicly to a privately owned company.

Exhibit 1–4 summarizes the various forms corporate restructuring may take.

FRIENDLY VERSUS HOSTILE TAKEOVERS

In a friendly takeover of control, the target’s board and management are receptive to the idea and recommend shareholder approval. To gain control, the acquiring company usually must offer a premium to the current stock price. The excess of the offer price over the target’s premerger share price is called a purchase premium or acquisition premium and reflects the perceived value of obtaining a controlling interest (i.e., the ability to direct the activities of the firm) in the target, the value of expected synergies (e.g., cost savings) resulting from combining the two firms, and any overpayment for the target firm. Overpayment is the amount an acquirer pays for a target firm in excess of the present value of future cash flows, including synergy. Present value is an estimate of the current value of future cash flows, taking into account the minimum financial rates of return required by investors and lenders. Cash received today has a higher value than cash received at a later date because it can be reinvested at some rate of interest, so future cash flows must be reduced by potential accumulated interest earnings to estimate their value today.

Analysts often attempt to identify the amount of premium paid for a controlling interest (i.e., control premium) and the amount of incremental

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19 U.S. merger premiums averaged about 38 percent between 1973 and 1998 (Andrade, Mitchell, and Stafford, 2001). Rossi and Volpin (2004) document an average premium of 44 percent during the 1990s for U.S. mergers. The authors also find premiums in 49 countries ranging from 10 percent for Brazil and Switzerland to 120 percent for Israel and Indonesia. The wide range of estimates may reflect the value attached to the special privileges associated with control in various countries. For example, insiders in Russian oil companies have been able to capture a large fraction of profits by selling some of their oil at below-market prices to firms they own.
EXHIBIT 1-4 Corporate Restructuring Process

Corporate Restructuring

- Operational Restructuring
  - Workforce Reduction/Realignment
  - Joint Venture/Strategic Alliance
  - Divestiture, Spinoff, or Carve-Out
  - Takeover or Buyout
  - Leveraged/Management Buyout

- Financial Restructuring
  - Hostile Takeover
  - Friendly Takeover
  - Merger
  - Consolidation
  - Acquisition of Assets
  - In Bankruptcy
  - Outside Bankruptcy
  - Statutory
  - Subsidiary

Stock Buyback
Reorganization/Liquidation

Introduction to Mergers and Acquisitions
value created that the acquirer is willing to share with the target’s sharehold-
ers. An example of a pure control premium is a conglomerate willing to pay a
price significantly above the prevailing market price for a target firm to gain
a controlling interest, even though potential operating synergies are limited.
In such an instance, the acquirer often believes it will recover the value of
the control premium by making better management decisions for the target
firm. It is important to emphasize that what is often called a control premium
in the popular or trade press is actually a purchase or acquisition premium
that includes both a premium for synergy and a premium for control.

The offer to buy shares in another firm, usually for cash, securities, or
both, is called a tender offer. Although tender offers are used in a number
of circumstances, they most often result from friendly negotiations (i.e.,
negotiated tender offers) between the boards of the acquirer and the tar-
get firm. Those that are unwanted by the target’s board are referred to as
hostile tender offers. Self-tender offers are used when a firm seeks to repur-
chase its own stock.

An unfriendly takeover or hostile takeover occurs when the ini-
tial approach was unsolicited, the target was not seeking a merger, the
approach was contested by the target’s management, and control changed
hands (i.e., usually requiring the purchase of more than half of the target’s
voting common stock). The acquirer may attempt to circumvent manage-
ment by offering to buy shares directly from the target’s shareholders (i.e.,
a hostile tender offer) and by buying shares in a public stock exchange
(i.e., an open market purchase).

Friendly takeovers are often consummated at a lower purchase price
than hostile transactions. A hostile takeover attempt may attract new bid-
ders who might not otherwise have been interested in the target—called
putting the target in play. In the ensuing auction, the final purchase price
may be bid up to a point well above the initial offer price. Acquirers pre-
fer friendly takeovers because the postmerger integration process is usually
more expeditious when both parties are cooperating fully. For these rea-
sons, most transactions tend to be friendly.

**ALTERNATIVE WAYS TO INCREASE SHAREHOLDER VALUE**

A business alliance refers to a form of combination other than M&A. Such
alliances include joint ventures, strategic alliances, minority investments,
franchises, and licenses.

A joint venture (JV) is a cooperative business relationship formed by
two or more separate parties to achieve common strategic objectives.
While the JV is often an independent legal entity such as a corporation or partnership formed for a specific period and for a specific purpose, it may take any organizational form deemed appropriate by the parties involved. Each JV partner continues to exist as a separate entity. JV corporations have their own management reporting to a board of directors comprising representatives of the participating companies.

A **strategic alliance** generally falls short of creating a separate legal entity. A strategic alliance may be an agreement to sell each firm’s products to the other’s customers or to co-develop a technology, product, or process. The terms of such an agreement may be legally binding or largely informal.

A **minority investment** requires little commitment of management time and may be highly liquid if the investment is in a publicly traded company. A company may choose to assist small or startup companies in the development of products or technologies it finds useful, receiving representation on the board in exchange for the investment. Such investments may also be opportunistic in that passive investors take a long-term position in a firm believed to have significant appreciation potential. For example, Warren Buffett’s Berkshire Hathaway firm invested $5 billion in Goldman Sachs in 2008 by acquiring convertible preferred stock that pays a 10 percent dividend. Berkshire Hathaway also received warrants to purchase $5 billion of Goldman Sachs common stock at $115 per share. This exercise price is less than one-half of the share price only a year earlier.

A **license**, which requires no initial capital, provides a convenient way for a company to extend its brands to new products and new markets. The company simply licenses its brand names to others. A company may also gain access to a proprietary technology through the licensing process. A **franchise** is a specialized form of a license agreement that grants a privilege to a dealer from a manufacturer or franchise service organization to sell the franchiser’s products or services in a given area. Such arrangements can be exclusive or nonexclusive. Under a franchise agreement, the franchiser may offer the franchisee consultation, promotional assistance, financing, and other benefits in exchange for a share of the franchise’s revenue. Franchises represent a low-cost way for the franchiser to expand, because the franchisee usually provides the needed capital. The success of franchising, though, has been largely limited to industries such as fast-food services and retail in which a successful business model can be easily replicated.

The major attraction of these alternatives to outright acquisition is the opportunity for each partner to gain access to the other’s skills, products, and markets at a lower overall cost in terms of management time
and money. Major disadvantages include limited control, the need to share profits, and the potential loss of trade secrets and skills to competitors.

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Mergers and acquisitions are an important change agent. Businesses are constantly churning, and only the most innovative and nimble survive. When companies do fall to the competition, it is often through merger, acquisition, bankruptcy, downsizing, or some other form of corporate restructuring. The pace at which failing businesses disappear often depends on their size, the perceived potential impact they have on the economy, and how critical they are to national security. Large businesses may linger for an extended period as their creditors renegotiate loans. Today, the concept of “too big to fail” has led to huge government subsidies to dying businesses to prevent what may be inevitable.

While M&As are a critical component in the business strategy of some firms, it is important to remember that they represent only one of several ways of executing business plans. There are alternatives, from the various forms of business alliances to going it on your own through a solo venture. Which method is chosen depends on management’s desire for control, willingness to accept risk, and the range of opportunities present at a particular moment in time.

A Case in Point: Mars Buys Wrigley in One Sweet Deal

Wrigley Corporation, a U.S.-based leader in gum and confectionary products, had been losing market share since 2006 to Cadbury Schweppes in the U.S. gum market. Mars Corporation, a privately owned candy company with annual global sales of $22 billion, sensed an opportunity to achieve sales, marketing, and distribution synergies by acquiring Wrigley. On April 28, 2008, Mars announced that it had reached an agreement to merge with Wrigley for $23 billion in cash.

The terms of the agreement were approved unanimously by the boards of both firms. Wrigley shareholders would receive $0.00 in cash for each share of common stock outstanding. The purchase price represented a 28 percent premium to Wrigley’s closing share price of $62.45 on the announcement date. The merged firms would, in 2008, enjoy a 14.4 percent share of the global confectionary market, annual revenue of $27 billion, and 64,000 employees worldwide.

When the deal was consummated in September 2008, it was a strategic blow to the efforts of Cadbury Schweppes to continue as the market leader in the global confectionary market with its gum and chocolate business. Prior to the announcement, Cadbury had a 10 percent worldwide market share.
Wrigley became a separate standalone subsidiary of Mars, with $5.4 billion in sales. The deal helps Wrigley augment its sales, marketing, and distribution capabilities. To provide more focus to the Mars brands and stimulate growth, Mars transferred its global nonchocolate confectionery sugar brands to Wrigley. Bill Wrigley, Jr., remains Executive Chairman of Wrigley, and the Wrigley management team remains in place. The combined companies now have substantial brand recognition and product diversity in six growth categories: chocolate, nonchocolate confectionery, gum, food, drinks, and pet-care products. The resulting confectionery powerhouse also expects to achieve significant cost savings by combining manufacturing operations and having a substantial presence in emerging markets.

Although mergers among competitors are not unusual, the deal’s highly leveraged financial structure is atypical of transactions of this type. Almost 90 percent of the purchase price was financed through borrowed funds, with the remainder financed largely by a third-party equity investor. Mars’ upfront exposure consisted of paying for closing costs from its cash balances in excess of its operating needs. JPMorgan Chase and Goldman Sachs provided the debt financing for the transaction, $11 billion and $5.5 billion, respectively. Berkshire Hathaway, a nontraditional source of high-yield financing, put in an additional $4.4 billion in subordinated debt. Typically, such financing would have been provided by investment banks or hedge funds and subsequently repackaged into securities and sold to long-term investors such as pension funds, insurance companies, and foreign investors, but the meltdown in the global credit markets in 2008 forced investment banks and hedge funds to withdraw from the high-yield market in an effort to strengthen their balance sheets. Berkshire Hathaway completed the financing of the purchase price by providing $2.1 billion in equity financing in exchange for a 9.1 percent ownership stake in Wrigley.

**Things to Think About:**

1. Why did Wrigley’s share price not rise to the $80 offer price following the announcement of the merger? Why did competitor Cadbury’s shares gain 3.5 percent following the announcement?
2. Speculate as to how the Wrigley family may have been convinced to sell their firm.
3. How did factors external to both firms specifically influence their decision to merge?
4. Would you characterize this transaction as a friendly or hostile takeover? Why was this particular approach taken?
5. Of the motivations for business combinations outlined in this chapter, which do you think were most applicable in this case study?

CHAPTER 2

What History Tells Us about M&A Performance

Although there is little question that the future of M&A activity will continue to evolve, reflecting new global competition and the changing regulatory climate, it will continue to be possible to draw parallels with the past. These insights should help us to understand how to adapt the structure and financing of future M&As.

Against this backdrop, this chapter discusses merger activity in terms of cycles, or waves, which tend to mirror changes in the business cycle as well as the regulatory environment and technological innovation. You will learn why they occur and just how important it is to understand how merger waves can be anticipated. You also will consider whether M&As, historically, have paid off for shareholders, bondholders, and society. Finally, you will explore a case that illustrates how the market-based process of creative destruction paves the way for new and innovative solutions to contemporary challenges and identifies the important role M&As have in this process.

MERGER AND ACQUISITION WAVES

The following sections discuss the determinants of M&A waves, the six discrete periods in which they have occurred, and why it is important to anticipate such waves.

Why M&A Waves Occur

M&A activity in the United States has tended to cluster in multiyear waves, with six such waves occurring since the late 1890s. There are two competing explanations for this phenomenon. One argues that merger waves occur when firms in industries react to “shocks” in their operating environments, such as from deregulation; the emergence of new technologies, distribution channels, or substitute products; or a sustained rise in commodity prices. The size and length of the M&A wave depends to

1 Brealey and Myers (2003); Martynova and Renneboog (2008); and Mitchell and Mulherin (1996).
a large part on how many industries are affected by these shocks, as well
as the extent of the impact. Some shocks, such as the emergence of the
Internet, are pervasive in their impact; others are more specific, such as
deregulation of financial services and utilities or rapidly escalating com-
modity prices. In response to shocks, firms within the industry often
acquire either all or parts of other firms.

The second argument is based on the misvaluation idea (discussed in
Chapter 1) and suggests that managers use overvalued stock to buy the assets
of lower-valued firms. For M&As to cluster in waves, goes the argument, valua-
tions of many firms (measured by their price-to-earnings or market-to-book
ratios compared to other firms) must increase at the same time. Managers
whose stocks are believed to be overvalued move concurrently to acquire
companies whose stock prices are lesser valued\(^2\) and, reflecting the influence
of overvaluation, the method of payment would normally be stock.\(^3\)

Experience suggests that the “shock” argument is a stronger one, espe-
cially if it is modified to include the effects of the availability of capital
in causing and sustaining merger waves. Capital availability plays a criti-
cal role in determining merger waves. Shocks alone, without sufficient
liquidity to finance the transactions, will not initiate a wave of merger
activity. Moreover, readily available, low-cost capital may cause a surge in
M&A activity even if industry shocks are absent,\(^4\) and this was particularly
important in the most recent M&A boom.

**First Wave (1897–1904): Horizontal Consolidation**

M&A activity in this first wave was spurred by a drive for efficiency, lax
enforcement of the Sherman Antitrust Act, westward migration, and tech-
nological change. Mergers during this period were largely horizontal and
resulted in increased concentration in primary metals, transportation, and
mining. Large companies absorbed small ones. In 1901, J. P. Morgan cre-
ated America’s first billion-dollar corporation, U.S. Steel—formed by the
combination of 785 separate companies, the largest of which was Carnegie
Steel. Other giants formed during this era include Standard Oil, Eastman
Kodak, American Tobacco, and General Electric. Fraudulent financing and
the 1904 stock market crash ended the boom.

\(^2\) Rhodes-Kropf and Viswanathan (2004); Shleifer and Vishny (2003).

\(^3\) Numerous studies confirm that long-term fluctuations in market valuations and the number of
takeovers are positively correlated. See Andrade et al. (2001); Ang and Cheng (2006); Daniel et al.
(1998); and Dong et al. (2006). However, whether high valuations contribute to greater takeover
activity or increased M&A activity boosts market valuations is less clear.

\(^4\) Harford (2005).
Second Wave (1916–1929): Increasing Concentration

Activity during this period was a result of the entry of the United States into World War I and the postwar economic boom. Mergers also tended to be horizontal and further increased industry concentration; for example, Samuel Insull built an empire of utilities with operations in 39 states. The stock market crash of 1929, along with passage of the Clayton Antitrust Act that further defined monopolistic practices, brought this era to a close.


This period of M&A activity was characterized by the emergence of financial engineering and conglomeration. A rising stock market and the longest period of uninterrupted growth in U.S. history to that time resulted in record price-to-earnings (P/E) ratios. Companies given high P/E ratios by investors learned how to grow earnings per share (EPS) through acquisition, rather than through reinvestment. Companies with high P/E ratios would often acquire firms with lower P/E ratios and increase the EPS of the combined companies, which in turn boosted the share price of the combined companies—so long as the P/E applied to the stock price of the combined companies did not fall below the P/E of the acquiring company before the transaction. To maintain this pyramiding effect, though, target companies had to have earnings growth rates sufficiently attractive to convince investors to apply the higher multiple of the acquiring company to the combined companies. In time, the number of high-growth, relatively low P/E companies declined, as conglomerates bid up their P/E's. The higher prices paid for the targets, coupled with the increasing leverage of the conglomerates, caused the “pyramids” to collapse.


The 1980s, a decade that saw the rise of the corporate raider, were characterized by the breakup of many major conglomerates and a proliferation of financial buyers using the hostile takeover (rarely used previously) and the leveraged buyout (LBO) as their primary acquisition strategies. Management buyouts and takeovers of U.S. companies by foreign acquirers became more common. Conglomerates began to divest unrelated acquisitions made in the 1960s and early 1970s; in fact, of acquisitions made outside the acquirer’s main line of business between 1970 and 1982, some 60 percent had been sold by 1989.5 In 1988, the mega-railroad Burlington Northern spun off its energy properties, Burlington Resources, for

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$4.2 billion. The same year, Mobil Oil sold retailer Montgomery Ward for $3.8 billion. In 1989, Paramount, formerly Gulf and Western Industries, sold its finance company, Associates First Capital, for $3.4 billion.

For the first time, takeovers of U.S. companies by foreign firms exceeded in number and dollars the acquisitions by U.S. firms of companies in Europe, Canada, and the Pacific Rim (excluding Japan). Foreign purchasers were motivated by the size of the market, limited restrictions on takeovers, the sophistication of U.S. technology, and the weakness of the dollar against major foreign currencies. Foreign companies also tended to pay substantial premiums for U.S. companies, because the strength of their currencies lowered the effective cost of acquisitions. Moreover, favorable accounting practices allowed foreign buyers to write off goodwill in the year in which it occurred, unlike U.S. firms that had to charge goodwill expense against earnings for many years.6 The largest cross-border deals in this period include the Beecham Group PLC (UK) purchase of the SmithKline Beckman Corporation for $16.1 billion in 1989, British Petroleum Corporation’s 1987 acquisition of the remaining 45 percent of Standard Oil Corporation for $7.8 billion, and Campeau Corporation of Canada’s 1988 purchase of Federated Department Stores for $6.5 billion.

The fortunes of LBOs waned during the decade’s second half. RJR Nabisco exemplified the challenges faced by LBOs during this period. Kohlberg, Kravis & Roberts (KKR) paid $24.5 billion for the company in 1988, a record purchase price at the time. Despite going public in 1991, RJR Nabisco struggled under the burden of its massive debt until the mid-1990s, when improving cash flow enabled the firm to pay off a significant portion. Other LBO transactions also fell on hard times. Toward the end of the 1980s, the level of merger activity tapered off in line with a slowing economy and widely publicized LBO bankruptcies. Moreover, the junk bond market dried up as a major source of financing with the demise of Drexel Burnham, the leading underwriter and “market-maker” for high-yield securities.

6 Goodwill represents the excess of the purchase price paid by the acquirer for the net assets acquired (i.e., assets purchased revalued to their current market values less acquired liabilities). Conceptually, it represents intangible value such as brand names and other forms of intellectual property. Prior to December 15, 2001, the value of goodwill on the acquirer’s balance sheet had to be written off (i.e., amortized) over as long as 40 years. This is no longer required, but it must be checked for impairment in the wake of any significant event that may reduce the value of the goodwill to less than what is shown on the acquirer’s balance sheet (such as the loss of key customer contracts or patent or copyright protection, or any diminution in the value of the brand of products acquired from the target firm). Whenever this occurs, the value of the goodwill must be revised downward to reflect these events with the amount of the downward revision charged against the firm’s current earnings.

Many believed that the M&As during the 1980s were largely overpriced and overleveraged, and junk bond or high-yield financing was considered unlikely to recover from the pummeling it had taken at the end of the decade. Consequently, many assumed that takeovers would not return to their levels of the late 1980s.

Although M&A activity did diminish during the 1990 recession, the number of transactions and the dollar volume rebounded sharply beginning in 1992. The longest economic expansion and stock market boom in U.S. history, uninterrupted by recession, was powered by a combination of the information technology revolution, continued deregulation, reductions in trade barriers, and the global trend toward privatization. Both the dollar volume and number of transactions continued to set records through the end of the 1990s before contracting sharply when the Internet bubble burst, a recession hit the United States in 2001, and global growth weakened.

Sixth Wave (2003–2007): The Rebirth of Leverage

U.S. financial markets during this sixth wave, especially from 2005 through 2007, were characterized by an explosion of highly leveraged buyouts and private equity investments (i.e., takeovers financed by limited partnerships) and the proliferation of complex securities collateralized by pools of debt and loan obligations of varying levels of risk. Much of the financing of these transactions, as well as mortgage-backed security issues, took the form of syndicated debt (i.e., debt purchased by underwriters for resale to the investing public).

The syndication process disperses such debt among many different investors. The issuers of the debt discharge much of the responsibility for the loans to others (except where investors have recourse to the originators if default occurs within a stipulated time). Under such circumstances, lenders have an incentive to increase the volume of lending to generate fee income by reducing their underwriting standards to accept riskier loans. After such loans are sold to others, loan originators are likely to reduce their monitoring of them. These practices, coupled with exceedingly low interest rates made possible by a world awash in liquidity, contributed to excessive lending and encouraged acquirers to overpay significantly for target firms. Exhibit 2-1 illustrates how these factors spread risk throughout the global credit markets.

Because it is difficult to determine the ultimate holders of the debt after it is sold, declining home prices and a relatively few highly publicized defaults in 2007 triggered concerns among lenders that the market value of their assets was actually well below the value listed on their balance
sheets. Subsequent write downs in the value of these assets reduced bank capital. Regulators require banks to maintain certain capital-to-asset ratios. To restore these ratios to a level comfortably above regulatory requirements, lenders restricted new lending. Bank lending continued to lag, despite efforts by the Federal Reserve to increase sharply the amount of liquidity in the banking system by directly acquiring bank assets and expanding the types of financial services firms that could borrow from the central bank, or by the U.S. Treasury’s direct investment in selected commercial banks and other financial institutions. Thus, the repackaging and sale of debt in many different forms contributed to instability in the financial markets in 2008. The limitations of credit availability affected not only the ability of private equity and hedge funds to finance new or refinance existing transactions, but also limited the ability of other businesses to fund their normal operations. Compounded by rapidly escalating oil prices in 2007 and the first half of 2008, these conditions contributed to the global economic slowdown in 2008 and 2009 and the concomitant slump in M&A transactions, particularly those that were highly leveraged.

Exhibit 2–2 provides the historical data underlying the trends in both global and U.S. merger and acquisition activity in recent years. M&A activity worldwide reached an historical peak in 2000 in terms of both the number and dollar value of transactions, following surging economic growth and the Internet bubble of the late 1990s. During 2000, the dollar value of transactions in the United States accounted for nearly one-half of the global total. The ensuing 2001 recession, escalating concerns about terrorism, and the subsequent decline in the world’s stock markets caused both the number and dollar value of global and U.S. transactions to decline
through 2002. By then, though, conditions were in place for a resurgence in M&A activity, and by 2007 the dollar value and number of announced global M&A transactions outside the United States reached new highs (see Exhibits 2–3 and 2–4). However, global merger activity dropped precipitously in 2008, reflecting a lack of credit, plunging equity markets, and the worldwide financial crisis.\(^7\) The number and dollar value of U.S. transactions as a percent of global M&A deals continued to decline.

**Similarities and Differences among Merger Waves**

Although patterns of takeover activity and their profitability vary significantly across M&A waves, there are common elements. Mergers have

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\(^7\) According to Dealogic, 1,307 previously announced deals valued at $911 billion were canceled in 2008, underscoring the malaise affecting the global M&A market. Deals sponsored by private equity firms and hedge funds hit a five-year low worldwide, falling 71 percent in 2008 from the prior year to $188 billion.
EXHIBIT 2-3  Dollar Value of Transactions: U.S. versus Global M&A*

EXHIBIT 2-4  Number of Transactions: U.S. versus Global M&A*

*All valuations include the value of debt assumed by the acquirer.
Source: Thompson Reuters and Dealogic.

...tended to occur during periods of sustained high rates of economic growth, low or declining interest rates, and a rising stock market. Historically, each merger wave has differed in terms of a specific development, such as the emergence of a new technology; industry focus, such as rail, oil, or financial...
services; degree of regulation; and type of transaction, such as horizontal, vertical, conglomerate, strategic, or financial (discussed in more detail later in this chapter). Exhibit 2-5 compares the six historical merger waves.

**Why It Is Important to Anticipate Merger Waves**

Not surprisingly, there is evidence that the stock market rewards firms that see and act on promising opportunities early and punishes those that merely imitate. Those pursuing these opportunities early on pay lower prices for target firms than the followers. One review of 3,194 public companies that acquired other firms between 1984 and 2004 found that the deals completed during the first 15 percent of a consolidation wave have share prices that outperform significantly the overall stock market as well as those deals that follow much later in the cycle when the purchase price of target firms tends to escalate. Consequently, those that are late in pursuing acquisition targets are more likely to overpay.

**DO MERGERS AND ACQUISITIONS PAY OFF FOR SHAREHOLDERS, BONDHOLDERS, AND SOCIETY?**

The answer to whether M&As pay off seems to depend on whom and over what period. On average, total shareholder gains around the announcement date of an acquisition or merger are significantly positive; however, most of the gain accrues to target firm shareholders. Moreover, in the three to five years after a takeover, many acquirer firms either underperform compared with their industry peers or destroy shareholder value. It is less clear whether this sub-par performance and value destruction is due to the acquisition or to other factors.

Researchers use a wide variety of approaches to measure the impact of takeovers on shareholder value. What follows is a discussion of the results of the two most common types of analyses of pre- and postmerger returns: the “event study” that examines abnormal stock returns to the shareholders.

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8 McNamara et al. (2008). The study defined a merger consolidation wave as a cycle in which the peak year had a greater than 100 percent increase from the first year of the wave, followed by a decline in acquisition activity of greater than 50 percent from the peak year. For some of the 12 industries studied, consolidation waves were as long as six years. There is also evidence that acquisitions early in the M&A cycle produce financial returns over 50 percent and, on average, create 14.5 percent more value for acquirer shareholders. See Gell et al. (2008).

9 In an analysis of 88 empirical studies between 1970 and 2006, Zola and Meier (2008) identified 12 different approaches to measuring the impact of takeovers on shareholder value. Of these studies, 41 percent use the event study method to analyze premerger returns, and 28 percent utilize long-term accounting measures to analyze postmerger returns.
<table>
<thead>
<tr>
<th>Time Period</th>
<th>Driving Force(s)</th>
<th>Type of M&amp;A Activity</th>
<th>Key Impact</th>
<th>Key Transactions</th>
<th>Factors Contributing to End of Wave</th>
</tr>
</thead>
<tbody>
<tr>
<td>1897–1904</td>
<td>Drive for efficiency, Lax antitrust law enforcement, Westward migration, Technological change</td>
<td>Horizontal consolidation</td>
<td>Increasing concentration: Primary metals, Transportation, Mining</td>
<td>U.S. Steel, Standard Oil, Eastman Kodak, American Tobacco, General Electric</td>
<td>Fraudulent financing, 1904 stock market crash</td>
</tr>
<tr>
<td>1916–1929</td>
<td>Entry into WWI, Post–WWI boom</td>
<td>Largely horizontal consolidation</td>
<td>Increased industry concentration</td>
<td>Samuel Insull builds utility empire in 39 states called Middle West Utilities</td>
<td>1929 stock market crash, Clayton Antitrust Act</td>
</tr>
<tr>
<td>Period</td>
<td>Economic factors</td>
<td>M&amp;A trends</td>
<td>Examples</td>
<td></td>
<td></td>
</tr>
<tr>
<td>-------------</td>
<td>----------------------------------------------------------------------------------</td>
<td>---------------------------------------------------------------------------</td>
<td>-------------------------------------------------------------------------</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1992–2000</td>
<td>Economic recovery, Booming stock market, Internet revolution, Lower trade barriers</td>
<td>Record levels of transactions in terms of numbers and prices</td>
<td>AOL acquires Time Warner, Vodafone AirTouch acquires Mannesmann, Exxon buys Mobil</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Globalization</td>
<td>Age of strategic mega-merger</td>
<td>Mittal acquires Arcelor, P&amp;G buys Gillette, Verizon acquires MCI</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Blackstone buys Equity Office Properties</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2003–2007</td>
<td>Low interest rates, Rising stock market, Booming global economy, Globalization</td>
<td>Increasing synchronicity among the world's economies</td>
<td>Loss of confidence in global capital markets, Economic slowdown in industrial nations</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Globalization</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
of both bidders and targets around the announcement of an offer (the “event”) and includes both successful (i.e., completed transactions) and unsuccessful takeovers, and the use of accounting measures to gauge the impact on shareholder value after the merger has been completed.

**Premerger Returns to Shareholders**

Positive *abnormal returns* represent gains for shareholders, which could be explained by such factors as improved efficiency, pricing power, or tax benefits. They are abnormal in the sense that they exceed what an investor would normally expect to earn for accepting a certain level of risk. For example, if an investor can reasonably expect to earn a 10 percent return on a stock but actually earns 25 percent due to a takeover, the abnormal or excess return to the shareholder would be 15 percent. Abnormal returns are calculated by subtracting the actual return from a benchmark indicating investors’ required returns, which often are approximated by the capital asset pricing model or the return on the S&P 500 stock index. Abnormal returns are forward looking in that share prices usually represent the present value of expected future cash flows. Therefore, the large announcement returns could reflect anticipated future synergies resulting from the combination of the target and acquiring firms.

Exhibit 2-6 provides some empirical evidence of abnormal returns to bidders and targets around announcement dates.

**High Returns for Target Shareholders in Successful and Unsuccessful Bids**

While averaging 30 percent between 1962 and 2001, abnormal returns for tender offers have risen steadily over time,\(^1\) reflecting the frequent bidder strategy of offering a substantial premium to preempt other potential bidders and the potential for revising the initial offer because of competing bids. Other contributing factors include the increasing sophistication of takeover defenses, as well as federal and state laws requiring bidders to notify target shareholders of their intentions before completing the transaction. Moreover, the abnormal gains tend to be higher for shareholders of target firms, whose financial performance is expected to deteriorate over the long term.\(^2\) This may suggest that the bidding firms see the highest potential for gain among those target firms whose management is viewed as incompetent. Returns from hostile tender offers typically exceed those from friendly

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10 Bhagat, Dong, Hirshleifer, and Noah (2005).
11 Ghosh and Lee (2000).
### EXHIBIT 2-6 Empirical Evidence on Abnormal Returns to Bidders and Targets Around Announcement Dates

<table>
<thead>
<tr>
<th>Total Gains from Takeovers</th>
<th>Target Shareholders</th>
<th>Bidder Shareholders</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. On average, takeovers increase the combined market value of the merged firms, with target shareholders earning large positive returns and bidding firm shareholders, on average, showing little or no abnormal return.</td>
<td>1. For the two-week period around the announcement date, returns range from 14–44%.</td>
<td>1. For the two-week period around the announcement date, average returns are close to zero when the target is a public firm. Some studies show small positive gains; others show small losses.</td>
</tr>
<tr>
<td>2. The largest gains are realized at the beginning of a takeover wave.</td>
<td>2. Average returns vary by period: 1960s: 18–19%; 1980s: 32–35%; 1990s: 32–45%</td>
<td>2. Returns can be 2–3% when the target is a private firm as the target’s performance benefits from increased monitoring by the acquiring firm.</td>
</tr>
<tr>
<td>3. Takeovers with the largest losses come during the second half of a takeover wave.</td>
<td>3. Average returns vary by type of bid: Hostile bids: 32%; Friendly bids: 22%</td>
<td>3. In the United States all-equity financed transactions are associated with negative abnormal returns and underperform all-cash bids.</td>
</tr>
<tr>
<td>4. Returns are higher for all-cash bids than for all-equity offers.</td>
<td>4. Returns are higher for all-cash bids than for all-equity offers.</td>
<td>4. In Europe, all-equity M&amp;As are associated with positive returns (often exceeding all-cash bids), reflecting the greater concentration of ownership and the tendency of blockholders of stock to more closely monitor management.</td>
</tr>
<tr>
<td>5. Target share prices often react as much as six weeks prior to an announcement reflecting speculation or insider trading.</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Adapted from Martynova and Renneboog (2008).

1 Results based on 65 studies of successful nonfinancial (friendly and hostile) M&As in the United States, the United Kingdom, and Continental Europe. Studies include horizontal, vertical, and conglomerate mergers, as well as tender offers. The studies also include related and unrelated takeovers; and all-stock, all-cash, and mixed forms of payment involving both public and private firms. Financial returns in these studies usually are computed over a period starting immediately before and ending shortly after the announcement date of the transaction. Moreover, these studies usually assume that share prices fully adjust to reflect anticipated synergies; therefore, they are believed to reflect both the short- and long-term effects of the acquisition.

2 Includes the sum of returns to target and acquirer shareholders.
mergers, which are characterized by less contentious negotiated settlements between the boards and management of the bidder and the target firm. Moreover, friendly takeovers often do not receive competing bids.

Unsuccessful takeovers may also result in significant returns for target company shareholders around the announcement date, but much of the gain dissipates if another bidder does not appear. The immediate gain in target share prices following a merger announcement disappears within a year if the takeover attempt fails. So, to realize abnormal returns, target firm shareholders must sell their shares shortly after the announcement of a failed takeover attempt.

Returns to Acquirer Shareholders May Not Be So Disappointing

In the aggregate, returns to acquirer shareholders are modest to slightly negative for successful takeovers, whether through tender offers or mergers. Bidder returns generally have declined slightly over time, as the premiums paid for targets have increased. Even if the excess returns are zero or slightly negative, these returns are consistent with returns in competitive markets in which financial returns are proportional to risk assumed by the average competitor in the industry. For unsuccessful takeovers, bidder shareholders have experienced negative returns in the 5 to 8 percent range, perhaps reflecting investors’ reassessment of the bidder’s business plan more than concerns about the acquisition.

Bidders with low leverage show a tendency to pay high purchase premiums. Not surprisingly, such bidders are in a position to pay higher prices than more leveraged bidders. However, this tendency may also result in such bidders overpaying for target firms, which increases the difficulty in earning the acquirer’s cost of capital on net acquired assets when they are restated to reflect their fair market value.

Focusing on aggregate returns to acquirer shareholders can be highly misleading. The results can be distorted by a relatively few large transactions. Whether abnormal returns to acquirers are positive or negative

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14 Grinblatt and Titman (2002).
16 Moeller et al. (2005). Acquirer returns around transaction dates were in the aggregate positive during the 1990s (around 1.5 percent), particularly during the 1990–1997 period. However, losses incurred by a relatively few mega-transactions between 1998 and 2001 offset much of the gains during the earlier period.
varies with the characteristics of the acquirer, the target, and the deal (discussed in more detail later in this chapter). Further, although event studies treat acquisitions as a single event, gains from a specific acquisition often depend on subsequent acquisitions undertaken to implement a firm’s business strategy, and because of potential synergies among the acquired firms (e.g., cost savings and cross-selling opportunities), the success or failure of these acquisitions should be evaluated in the context of the entire strategy and not as standalone transactions. Finally, there is evidence that the initial stock market reaction to the announcement of an acquisition often is biased or incomplete.

**Postmerger Returns to Shareholders**

The objective of examining postmerger accounting or other performance measures such as cash flow and operating profit, usually during the three- to five-year period following closing, is to assess how performance changed. The evidence, however, is conflicting about the long-term impact of M&A activity. Where some studies find a better-than-average chance that M&As create shareholder value, others find that as many as 50 to 80 percent have underperformed their industry peers or failed to earn their cost of capital. What may seem like a hubris-driven inability of CEOs and boards to learn from the past (because the number and size of transactions continue to increase over time) looks more like the result of

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17 Barkema and Schijven (2008). For example, in an effort to become the nation’s largest consumer lender, Bank of America spent more than $100 billion to acquire credit card company MBNA in 2005, mortgage lender Countrywide in 2007, and the investment firm/broker Merrill Lynch in 2008.

18 Harrison et al. (2005). Event studies assume that markets are highly efficient and share prices reflect all of the public and private information available with respect to the transaction. In practice, much of the data provided by the seller to the buyer are confidential and therefore largely unavailable to the public. Furthermore, the investing public often is unaware of the target’s specific business plan at the time of the announcement, making a comparison of whether to continue to hold or sell the target’s stock difficult. Zola and Meier (2008) noted that short-term event studies results do not correlate with any of the other measures of M&A performance because the “blip” in the financial returns of the buyer and seller on or about the announcement date often reflects the “collective bet” by investors on the probable success or failure of the merger. Such bets are often wrong, providing evidence contrary to the often- presumed efficiency of the financial markets.

19 In a review of 26 studies of postmerger performance during the 3 to 5 years after the merger, Martynova and Renneboog (2008) found that 14 showed a decline in operating returns, 7 provided positive (but statistically insignificant) changes in profitability, and 5 showed a positive and statistically significant increase in profitability. The diversity of conclusions about postmerger returns may be the result of sample and time selections, methodology employed in the studies, or factors unrelated to the merger such as a slowing economy (Barber and Lyon, 1997; Fama, 1998; Lyon, Barber, and Tsai, 1999).
methodological issues and the failure to distinguish among alternative situations in which M&As occur, leading to an understatement of potential returns to acquirers.20

Specific Characteristics Vary Acquirer Returns
Whether acquisitions lead to gains on average for acquirer shareholders is problematic. However, there is strong evidence that abnormal returns to acquirer shareholders are largely situational, varying according to size of the acquirer, the size of and type of target (i.e., publicly traded or private), and the form of payment (i.e., cash or stock).

Smaller Acquirers Tend to Realize Higher Returns
The size of the acquirer and financial returns realized on mergers and acquisitions are inversely related, with relatively smaller acquirers, on average, realizing larger abnormal returns than larger acquirers. Why? It seems to be a function of management overconfidence and the empire-building tendencies of large firms. For the 20-year period ending in 2001, researchers found that large firms destroyed shareholder wealth, whereas small firms created wealth.21

Returns Are Often Positive for Private or Subsidiary Targets
U.S. acquirers of private firms or subsidiaries of publicly traded firms often realize positive excess returns of 1.5 to 2.6 percent.22 Acquirers are inclined to pay less for nonpublicly traded companies due to the difficulty of buying private firms or subsidiaries of public companies. In both cases, shares are not publicly traded, and access to information is limited. Moreover, there may be fewer bidders for nonpublicly traded companies. Consequently, these targets may be acquired at a discount from their actual

20 Presumably, the longer the postmerger period analyzed, the greater the likelihood that other factors, wholly unrelated to the merger, will affect financial returns. Moreover, these longer-term studies are not able to compare how well the acquirer would have done without the acquisition.
21 Moeller et al. (2004). Small firms are defined as the smallest 25 percent of firms listed on the New York Stock Exchange each year during that 20-year period. Forty-six percent of a sample of 12,023 transactions involved acquisitions of private firms, 32 percent involved acquisitions of subsidiaries, and the remaining 22 percent involved acquisitions of public firms. Regardless of how they were financed (i.e., stock or cash) or whether they were public or private targets, acquisitions made by smaller firms had announcement returns 1.55 percent higher than a comparable acquisition made by a larger firm.
22 Ang et al. (2001); Fuller et al. (2002); and Moeller et al. (2005). Similar results were found in an exhaustive study of U.K. acquirers (Draper and Paudyal, 2006) making bids for private firms or subsidiaries of public firms, where the positive abnormal returns were attributed to the relative illiquidity of such businesses.
economic value (i.e., cash generation potential). As a consequence of this
discount, bidder shareholders are able to realize a larger share of the antici-
pated synergies resulting from combining the acquirer and target firms.

**Relatively Small Deals May Generate Higher Returns**

Average target size appears to play an important role in determining finan-
cial returns to acquirer shareholders.\(^2\) High-tech firms often acquire small,
but related, target firms to fill gaps in their product offerings. Consequently,
the contribution of these acquisitions should not be viewed individu-
ally, but in terms of their impact on the implementation of the acquirer’s
overall business strategy. Larger deals tend to be more risky for acquirers\(^2\)\(^4\)
and, as a percentage of the acquiring firms’ equity, show consistently lower
postmerger performance, possibly reflecting the challenges of integrating
large target firms and realizing projected synergies on a timely basis.

Under certain circumstances, though, larger deals may offer significant
positive abnormal rates of returns. For instance, acquirers’ returns from
buying product lines and subsidiaries of other companies tend to be higher
when the size of the asset is large relative to the buyer and small relative to
the seller.\(^2\)\(^5\) Specifically, in deals where the divested unit represents more
than 50 percent of the value of the buyer but less than 10 percent of the
value of the seller, acquirer returns are three times those of deals in which
the divested unit represents about the same share of value to the buyer
and seller. The implication is that parent firms interested in funding new
opportunities are more likely to divest relatively small businesses not ger-
mane to their core business strategy at relatively low prices to raise capital
quickly. Buyers are able to acquire sizeable businesses at favorable prices,
increasing the likelihood they will be able to earn their cost of capital.

**Cash Deals Often Exceed Equity-Financed Deals**

Managers tend to issue stock when they believe it is overvalued. Over time,
investors learn to treat such decisions as signals that the stock is overval-
ued and sell their shares when the new equity issue is announced, causing
the firm’s share price to decline. There is considerable evidence that bidd-
ing firms using cash to purchase the target firm exhibit better long-term

\(^2\) For the 10-year period ending in 2000, high-tech companies, averaging 39 percent annual total
return to shareholders, acquired targets with an average size of less than $400 million, about
1 percent of the market value of the acquiring firms (Frick and Torres, 2002).

\(^2\)\(^4\) Hack Barth et al. (2008).

\(^2\)\(^5\) Gell et al. (2008).
performance than do those using stock, since investors anticipate that stock-financed mergers underperform precisely because investors treat stock financing as a signal that shares are overvalued.  

Using stock to acquire a firm often results in announcement-period gains to bidder shareholders that dissipate within three to five years, even when the acquisition was successful. These findings imply that shareholders selling around the announcement dates may realize the largest gains from either tender offers or mergers. Target shareholders who hold onto the acquirer’s stock received as payment for their shares may see their gains diminish over time.

Some argue that equity overvaluation occurs when a firm’s management cannot expect to make investments that will sustain the current share price except by chance. Consequently, management will be enticed to pursue larger, more risky investments (such as unrelated acquisitions) in a vain attempt to support the overvalued share price. These actions destroy shareholder value because the firm is unable to earn its cost of capital. Consequently, the longer-term performance of the combined firms suffers as the stock price declines to its industry average performance.

Abnormal returns to acquirers are negatively related to equity offers, but not to cash offers. However, there appears to be no difference in abnormal returns for cash offers for public firms, equity offers for public firms, and equity offers for private firms when such firms exhibit similar business-specific risk (e.g., institutional ownership, growth rates, leverage, product offerings, etc.).

Successful acquirers using stock as the form of payment significantly outperform unsuccessful attempts by a wide margin. It seems that the relatively better performance of successful stock-financed acquirers results from their ability to use their overvalued stock to buy the target firm’s assets relatively inexpensively.

26 Heron and Lie (2002); Linn and Switzer (2001); Megginson et al. (2003); and Schleifer and Vishny (2003).
27 Agrawal and Jaffe (1999); Black et al. (2000); Deogun and Lipin (2000); and Rau and Vermaelen (1998).
29 Moeller et al. (2007).
30 Savar and Lu (2009). Over the first year, the mean abnormal financial return for acquirers using stock is a negative 7 percent, reaching a negative cumulative 13 percent at the end of three years. However, acquirers using stock who fail in their takeover attempts do even worse, experiencing negative returns of 21 percent and 32 percent after one year and three years, respectively, following their aborted takeover attempts.
31 Studies of European firms indicate that postmerger returns to bidders using stock often are higher than those using cash. These results may reflect the greater concentration of ownership in European firms than in the United States and the tendency of large shareholders to more closely monitor the actions of management (Martynova and Renneboog, 2008).
Acquirer Experience May Not Improve Long-Term Performance of Combined Companies

Experience is a necessary but not sufficient condition for successful acquisitions. It contributes to improved financial returns, it appears, only if it is applied to targets in the same or similar industries, or in the same or similar geographic or cultural regions.\(^{32}\)

Abnormal returns to serial acquirers (i.e., firms making numerous and frequent acquisitions) have tended to decline from one transaction to the next.\(^{33}\) This is typically attributed to the CEO of the serial acquirer becoming overconfident with each successive acquisition. The CEO then tends to overestimate the value of synergies and the ease with which they can be realized. Now subject to hubris, the CEO tends to overpay for acquisitions.\(^{34}\)

Bidder Returns Are Good Predictors of Successful Transactions

There is evidence that the magnitude of abnormal returns to acquirers around the announcement date is a good predictor of whether the initial offer price will be renegotiated or that the deal will be canceled.\(^{35}\) The acquirer’s management will react to a significant negative decline in its stock immediately following a merger announcement as investors display their displeasure with the deal. Cancellation is much less likely if an agreement of purchase and sale was signed before the announcement.

Reneging on a signed agreement can be expensive. After Getty Oil reneged on a merger agreement with Pennzoil in the early 1980s in favor of merging with Texaco, a federal court ruled that Texaco would have to pay Penzoil $10 billion in compensatory damages.

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\(^{32}\) This is the conclusion from Barkema and Schijven (2008), who performed an extensive survey of the literature on how firms learn from past acquisitions.

\(^{33}\) Billett and Qian (2006); Conn et al. (2005); Fuller et al. (2002); and Ismail (2005).

\(^{34}\) These findings are in sharp contrast with the findings that acquirers have great potential to learn from their mistakes, suggesting that serial acquirers are more likely to earn returns in excess of their cost of capital (Harding and Rovit, 2004). Aktkas et al. (2007) proposed an alternative explanation for the role of hubris in the decline in abnormal acquirer returns for serial acquirers. If acquirers are learning from prior acquisitions, they should improve their selection of, and ability to, integrate target firms. Therefore, the risk of each successive acquisition should decline. If risk associated with the successive acquisitions declines faster than the abnormal return, risk-adjusted acquirer returns could rise. If so, CEOs of highly acquisitive firms should be willing to bid more aggressively for targets as the perceived risk associated with such targets declines. As such, abnormal returns are simply declining in line with the level of perceived risk for experienced acquirers.

\(^{35}\) Luo (2005), based on a sample of 1,576 transactions between 1995 and 2001.
Bondholder Payoffs

Mergers and acquisitions have relatively little impact on abnormal returns either to acquirer or target bondholders, except in special situations, due in part to the relationship between leverage and management discipline. Increasing leverage or default risk imposes discipline on management to improve operating performance, whereas decreasing leverage has the opposite effect. Moreover, decreasing leverage encourages controlling shareholders to increase future borrowing to enhance financial returns to equity. The impact may be negligible even if the transaction results in a larger, less-risky business.

Payoffs for Society

Some observers argue that M&As are not good for society because they result in increased concentration, and larger firms with larger market share are in a better position to raise prices than they would have been had the merger not taken place. There is little evidence, however, that this is the case.

First, there is no evidence that M&A activity results in increasing industry concentration. Although mergers and acquisitions have continued to increase in number and average size during the past 30 years, M&A activity, since 1970, has not increased industry concentration in terms of the share of output or value produced by the largest firms in the industry, either in manufacturing or in the overall economy.

Further, the bulk of the evidence suggests that M&A activity results in improved operating efficiencies and lower product prices than would have been the case without the merger having taken place. Gains in aggregate shareholder value are attributable more to the improved operating efficiency

36 Renneboog and Szilagyi (2007).
37 The empirical evidence is ambiguous. A study by Billett, King, and Mauer (2004) showed slightly negative abnormal returns to acquirer bondholders regardless of the acquirer’s bond rating; they used a sample of 831 U.S. transactions between 1979 and 1998. However, they also found that target firm holders of below-investment-grade bonds (i.e., BBB-) earn average excess returns of 4.3 percent or higher around the merger announcement date, when the target firm’s credit rating is less than the acquirer’s and when the merger is expected to decrease the target’s risk or leverage. Maquierira, Megginson, and Nail (1998) showed positive excess returns to acquirer bondholders of 1.9 percent, and 0.5 percent for target bondholders, but only for nonconglomerate transactions; their sample included 253 U.S. transactions from 1963 to 1996. Another study, using a sample of 225 European transactions between 1995 and 2004, found small positive returns to acquirer bondholders of 0.56 percent around the announcement date of the transaction (Renneboog and Szilagyi, 2006).
38 Carlton and Perloff (1999).
of the combined firms than to increased market or pricing power. In fact, corporate transactions seem to result in an overall improvement in efficiency by transferring assets from those who are not using them effectively to those who can.

**WHY SOME M&As FAIL TO MEET EXPECTATIONS**

The notion that most M&As fail in some substantive manner is not supported by the evidence. In fact, the failure of an M&A to meet expectations depends entirely on how you define failure. The failure rate is low if failure is defined as the eventual sale or liquidation of the business, but is higher if failure is defined as the inability to meet or exceed financial objectives. Managers are often very satisfied with their acquisitions, so the failure rate is low if failure is defined as not achieving strategic, nonfinancial objectives.

Although there are many cases in which acquirers earn positive abnormal financial returns around the transaction announcement date, firms often continue to outperform their peers in the years immediately following closing; the average firm is still earning at, or close to, its cost of capital—even though the average abnormal return for all bidders tends to be about zero. Still, these cases may still be considered a failure because acquirers often promise to achieve financial returns well in excess of their cost of capital.

No single factor seems likely to be the cause of M&As failing to meet expectations. There are, however, three explanations to which this is most commonly attributed: overpaying, overestimating synergies, and a slow pace of integration.

**Overpaying**

Overpaying for a target firm increases the hurdles an acquirer must overcome to earn its cost of capital because there is little or no margin of error in achieving anticipated synergies on a timely basis. Consequently, the

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39 Akhigbe, Borde, and Whyte (2000); Ghosh (2004); Shahrur (2005); and Song and Walking (2000).
41 Brouthers, van Hastenburg, and van den Ven (1998).
42 In an exhaustive study of 22 different papers examining long-run postmerger returns, Agrawal and Jaffe (1999) separated financial performance following mergers and hostile tender offers. Reviewing a number of arguments purporting to explain postmerger performance, they deemed most convincing the argument that acquirers tend to overpay for so-called high-growth glamour companies based on their past performance.
postmerger share price for such firms should underperform broader industry averages as future growth slows to more normal levels.

The legacy of overpaying is long-lasting. By substantially overpaying for an acquisition, acquirers condemn themselves to having to improve profitability dramatically to earn the financial returns required by investors on a higher net asset base (including the fair market value of the target’s net assets).

**Overestimating Synergies**

If acquirers have significantly overestimated potential synergy, they will be unable to realize these returns. With so much overpaying in the late 1990s, many firms have been forced to write off goodwill associated with prior acquisitions or major portions of the acquired assets. As a result of the decline in the stock market in 2000 and 2001, many firms’ share prices were trading at levels significantly less than book value. In an eye-popping first-quarter 2002 write-off, for instance, AOL effectively admitted that it had overpaid for Time Warner by more than one-half; AOL said it would reduce the value of the goodwill associated with the transaction by $60 billion. In 2004, MCI took a record-setting $75 billion write-off for acquisitions made by the company when it was named WorldCom.

**Slow Integration**

Integration frequently turns out to be more challenging than anticipated (this is detailed in Chapter 10). Consequently, paying less than “fair market value” often enables acquirers to realize attractive financial returns even if they are unable to realize quickly the forecast amount of cost savings and revenue. However, no matter what is paid for the target firm, success will be elusive if the strategy justifying the acquisition is severely flawed.

**LONG-TERM PERFORMANCE IS SIMILAR FOR M&As, BUSINESS ALLIANCES, AND SOLO VENTURES**

Even if a substantial percentage of M&As underperformed their peers or failed to earn appropriate financial returns, it is important to note that there is little compelling evidence that growth strategies undertaken as an alternative to M&As fare any better. Such alternatives include solo ventures, in which firms reinvest excess cash flows, and business alliances, including joint ventures, licensing, franchising, and minority investments.
Failure rates among alternative strategies tend to be remarkably similar to those documented for M&As.43

M&A activity, which has tended to cluster in the United States in multiyear waves, seems to be triggered by industry shocks, assuming there is sufficient credit market liquidity to finance the upsurge in transactions. Typically, mergers occur during periods of sustained high rates of economic growth, low or declining interest rates, and a rising stock market.

Although M&As clearly pay off for target company shareholders around announcement dates, shareholder wealth creation in the three to five years that follow closing is less certain. The longer the postacquisition period, the greater the likelihood that other factors will affect performance. When mergers fail to satisfy expectations, the reason is usually that synergies were overestimated, resulting in overpayment, as well as the slow pace of postmerger integration and the lack of a coherent business strategy.

The success rate for M&As is very similar to alternative growth strategies that may be undertaken, such as reinvesting excess cash flow in the firm (i.e., solo ventures) or business alliances.

A Case in Point: Consolidation in the Telecommunications Industry
The blur of consolidation in the U.S. telecommunications industry in recent years illustrates dramatically how free market forces can radically restructure the competitive landscape, spurring improved efficiency and innovation. It is a process economic historian Joseph Schumpeter has described as “creative destruction.”44

43 ACNielsen (2002) estimated the failure rate for new product introductions at well over 70 percent. Failure rates for alliances of all types exceed 60 percent (Ellis, 1996; Klein, 2004).
44 Schumpeter uses “creative destruction” to describe the free-market process by which new technologies and deregulation create new industries, often at the expense of existing ones. In the short run, the process of “creative destruction” can have a highly disruptive impact on current employees whose skills are made obsolete, investors and business owners whose businesses are no longer competitive, and communities that are ravaged by increasing unemployment and diminished tax revenues. In the long run, though, the process tends to raise living standards by boosting worker productivity and increasing real income and leisure time, stimulating innovation, and expanding the range of products and services offered, often at a lower price, to consumers. Much of the change spurred by the process of “creative destruction” takes the form of mergers and acquisitions. For more information about the concept of “creative destruction,” see Schumpeter (2008).
In 2005, Verizon acquired MCI. That same year, SBC acquired AT&T and then merged with BellSouth in 2006—later to be renamed AT&T to take advantage of the globally recognized brand name. In all, Verizon and SBC spent about $170 billion in acquisitions during this two-year period, pushing these two firms to the top of the U.S. telecommunications industry.

Buying their long-distance rivals gave SBC and Verizon instant access to corporate customers that purchase discounted packages of telecom services, and it came at a lower cost than marketing to these customers and replicating their networks. There are other cost savings that come from eliminating overlapping functions. Buying BellSouth also gave the new AT&T full control over Cingular (later renamed AT&T Wireless), the biggest U.S. mobile phone operator. As of January 2008, 18 percent of the U.S. population were still without cell phones, so there is still room for growth that can help offset the decline in the number of “landlines.”

There is still considerable competition, particularly from nontraditional sources. Many cable companies have been racing to add phone service to their TV and Internet packages. Phone companies are responding with offers of combined cell phone, Internet, and landline phone service. The growing expansion of new fiberoptic networks is accelerating the pace at which TV services are being offered. Internet telephony services such as Vonage give consumers options besides cable and telephone companies’ calling services. Local phone companies are also expected to face increasing competition from wireless calling. In December 2004, Sprint and Nextel Communications merged to form a wireless giant in a $35 billion transaction aimed at competing directly with traditional phone lines.

Changes in technology mean that there will likely be many more companies competing against the phone companies than just cable companies. The integration of voice and data on digital networks and the arrival of Internet calling have attracted many new competitors for phone companies, including Microsoft, Sony, Google, and others.

The implications of all this consolidation remain unclear. Some analysts believe fewer providers will leave business customers with less leverage. Cable is an ineffective alternative to phone service for business customers because the U.S. cable infrastructure was built to offer television service to homes, so cable networks do not reach all commercial areas. Cable companies are often unwilling to invest the capital required for expansion because they cannot be clear that they will acquire the customer density necessary to achieve the desired financial returns. Other analysts see a continuation of very competitive price competition for consumers based on price. Telecom companies are rushing to sell consumers bundles of services that include local and long-distance service, cellular service, and Internet access for one monthly fee.
These competitive forces are likely to prevent higher prices for local phone service, which is already eroding at a rapid rate due to emerging technologies such as Internet calling. In fact, when adjusted for inflation, prices paid by consumers and businesses are a fraction of what they were a generation ago.

**Things to Think About:**

1. How have technological and regulatory changes affected competition in the telecommunications industry?

2. How have technological and regulatory changes affected the rate of innovation and customer choice in the telecom industry?

3. The process of “creative destruction” has stimulated substantial consolidation in the U.S. telecom industry. Is bigger always better? Why or why not? (Hint: Consider the impact on a firm’s operating efficiency, speed of decision making, creativity, ability to affect product and service pricing, and so on.)

4. To determine the extent to which industry consolidation is likely to lead to higher, lower, or unchanged product selling prices, you need to consider current competitors, potential competitors, the availability of substitutes, and customer pricing sensitivity (i.e., elasticity). Explain why.

5. What factors motivated Verizon and SBC to acquire MCI and AT&T, respectively? Discuss these factors in terms of the motives for mergers and acquisitions described in Chapter 1.

Answers can be found at:
Developing Takeover Strategies and the Impact on Corporate Governance

Hollywood dramatizes the motivation for corporate takeovers as “excessive greed.” The press often portrays them as “job destroyers.” From other quarters, corporate takeovers are hailed as a way to dislodge incompetent management. Shareholders often hail them as a source of windfall gains. The reality is that corporate takeovers may be a little of all of these things.

A number of tactics are commonly used to acquire a company, including bear hugs, proxy contests, and hostile tender offers; they may be more or less effective, depending on circumstances. The “corporate takeover markets” in which these tactics are employed serve two important functions in a free market economy. First, such markets facilitate the allocation of resources to sectors of the economy in which they can be used most efficiently. Second, they serve as a mechanism for disciplining underperforming corporate managers. When hostile takeover attempts or proxy fights succeed in replacing such managers, they help encourage corporate governance practices that promote corporate stakeholder rights.

CORPORATE GOVERNANCE

What is corporate governance? The common definition is fairly straightforward; the term refers broadly to the rules and processes by which a business is controlled, regulated, or operated. There is, though, no universally accepted goal for corporate governance. Traditionally, the goal has been to protect shareholder rights. More recently, this goal has expanded to encompass additional corporate stakeholders, including customers, employees, the government, lenders, communities, regulators, and suppliers. For our discussion here, corporate governance is about leadership and accountability, and it involves all those factors internal and external to the firm that interact to protect the rights of corporate stakeholders.
EXHIBIT 3-1 Factors Affecting Corporate Governance

External to the Firm

Legislation:
- Federal & State Securities Laws
- Insider Trading Laws
- Antitrust Laws

Internal to the Firm

Board of Directors/Management:
- Independence of Board, Audit, and Compensation Committees
- Separation of CEO and Chairman Positions

Internal Controls & Incentives Systems:
- Financial Reporting
- Executive Compensation
- Personnel Practices
- Succession Planning

Antitakeover Defenses:
- Pre-offer
- Postoffer

Corporate Culture & Values

External to the Firm

Regulators:
- Government Agencies
- Public Exchanges (e.g., Listing Requirements)
- Standards Setting Boards (e.g., FASB)

Institutional Activism:
- Pension & Mutual Funds
- Hedge Funds & Private Equity Investors

Corporate Takeover Market:
- Hostile Takeover Tactics (e.g., Tender Offers, Proxy Contests)
Exhibit 3-1 illustrates the range of factors affecting corporate governance, including the corporate takeover market.

**Alternative Models of Corporate Governance**

The ultimate goal of a successful corporate governance system should be to hold those in power accountable for their actions. Where capital markets are liquid, investors discipline bad managers by selling their shares—referred to as the market model of corporate governance. Where capital markets are illiquid, bad managers are disciplined by those owning large blocks of stock in the firm or by those whose degree of control is disproportionate to their ownership position. This is the control model of corporate governance, and it may develop through the concentration of shares having multiple voting rights (i.e., so-called supervoting shares) in the hands of a few investors.

**Internal Factors That Affect Corporate Governance**

Corporate governance is affected by the integrity and professionalism of the firm’s board of directors, as well as by the effectiveness of the firm’s internal controls and incentive systems, takeover defenses, and corporate culture and values.

**Board of Directors/Management**

The board advises the firm’s CEO, who runs the daily operations, and reviews the quality of recommendations the CEO receives from others in corporate management. The board also hires, fires, and sets CEO compensation. Moreover, the board is expected to oversee management, corporate strategy, and the company’s financial reports to shareholders, as well as deal with situations in which managers as agents of the shareholder make decisions that are not in the best interests of shareholders (this is the agency problem discussed in Chapter 1).

Some board members may also be employees or family members (most often from the extended family of the firm’s founder) and thus subject to potential conflicts of interest that cause them to act in ways not necessarily in stakeholders’ interests. This has led some observers to argue that boards should be composed primarily of independent directors and that different individuals should hold the CEO and board chairman positions.¹

¹ Various researchers (Dahya et al., 2001; Herermalin, 2006; and Huson et al., 2001) have documented a number of trends regarding board composition. The proportion of independent directors has steadily increased in the United States and in other countries; outside directors rose from an average of 35 percent in 1989 to 61 percent in 1999. Second, the use of incentive compensation for outside directors has increased significantly. Some 84 percent of firms reporting to a Conference Board...
**Internal Controls and Incentive Systems**

Compensation is an integral part of the incentive systems internal to a firm that are used to manage the firm in the manner the board deems most appropriate. This is strongly influenced by external factors. U.S. tax rules and accounting standards send mixed signals. On the one hand, the U.S. tax code requires compensation above $1 million to be “performance based” and therefore tax deductible. This encourages firms to pay executives with stock options rather than with cash. In contrast, firms are now required to charge the cost of options against current earnings (in the past, they could defer such costs), which has a dampening effect on the widespread use of options. Moreover, the current practice of fixed strike or exercise prices (i.e., prices at which option holders can buy company stock) for options led to enormous profits simply because the overall stock market rose even though a given firm’s performance lagged the overall market.

Recent government efforts to cap CEO compensation in those firms receiving taxpayer-funded bailouts are likely to result in executives being compensated in-kind (i.e., receiving services paid by the firm) and may discourage the most talented executives from seeking employment in such firms. The most talented managers still can receive large compensation packages in companies financed by private equity, hedge funds, and venture capital.

By eliminating such tax rules, boards would be encouraged to design compensation plans that reward exceptional performance rather than the exploitation of tax rules. Furthermore, linking option strike prices to the performance of the company’s stock price relative to the stock market would ensure that increases in the stock market do not benefit managers whose companies are underperforming. Another way to align corporate managers’ interests with those of other stakeholders is for managers to own a significant portion of the firm’s outstanding stock, or for the managers’ ownership of the firm’s stock to comprise a substantial share of their personal wealth, but the percentage change in such ownership has been relatively small over the decades.\(^2\)

An alternative to concentrating ownership in management is for one or more shareholders who are not managers to accumulate a significant block of voting shares. Corporations having outside shareholders with

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\(^2\) The proportion of shares owned by managers of public firms in the United States grew from an average of 12.9 percent in 1935 to an average of 21.1 percent in 1998 (Economic Report to the President, 2003, p. 86).
large blocks of stock may be easier to acquire, thereby increasing the risk to managers that they will be ousted for poor performance.

_Antitakeover Defenses_  
A firm’s management and board may employ takeover defenses to gain leverage in negotiating with a potential suitor, or to solidify the current management’s position within the firm. There is a range of defensive actions; they are detailed in Chapter 4.

_Corporate Culture and Values_  
Although internal systems and controls are important, good governance also results when the employee culture is instilled with appropriate core values and behaviors. Setting the right tone and direction comes from the board of directors and senior management and their willingness to behave in a manner consistent with what they demand from other employees. One can only speculate as to the degree to which the scandal that rocked Hewlett-Packard (HP) in late 2006 undermined the firm’s internal culture. Some of HP’s top managers had sanctioned internal (and illegal) spying on the firm’s board members to gain access to their private information. It should come as no surprise that such actions drastically reduce employee confidence in senior management pronouncements about desired corporate values and behaviors.

_Factors External to the Firm_  
Federal and state legislation, the court system, regulators, institutional activists, and the corporate takeover market all play an important role in maintaining good corporate governance practices.

_Legislation and the Legal System_  
In the United States, the Securities Acts of 1933 and 1934 form the basis for modern securities legislation; these acts created the Securities and Exchange Commission (SEC) and charged it with writing and enforcing securities regulations. The U.S. Congress has since transferred some enforcement tasks to public stock exchanges, such as the New York Stock Exchange (NYSE), which operate under SEC oversight as self-regulating organizations. The SEC itself has delegated certain responsibilities for setting and maintaining accounting standards to the Financial Accounting Standards Board. Under the Sarbanes–Oxley Act of 2002, the SEC is overseeing the Public Company Accounting Oversight Board, whose primary
task is to develop, maintain, and enforce standards that guide auditors in monitoring and certifying corporate financial reports. The aim of the Sarbanes–Oxley Act was to achieve greater corporate transparency with respect to financial statements, but the events of 2008 and 2009 in the financial and real estate markets underscore how legislative solutions often fail to achieve their intended results. State legislation also has a significant impact on governance practices by requiring corporate charters to define the responsibilities of boards and managers with respect to shareholders.

**Regulators**

The SEC, Federal Trade Commission (FTC), and Department of Justice (DoJ) can discipline firms with inappropriate governance practices through formal and informal investigations, lawsuits, and settlements. In mid-2003, the SEC approved new listing standards that would put many lucrative, stock-based pay plans to a shareholder vote, thus giving investors in more than 6,200 companies listed on the NYSE, NASDAQ, and other major markets significant control over CEO pay packages. In January 2007, the SEC implemented additional disclosure requirements for CEO pay and perks that exceed $10,000 in value.

**Institutional Activists**

Pension funds, hedge funds, private equity investors, and mutual funds have become increasingly influential institutions that can affect the policies of companies in which they invest. Chapter 5 explores the growing evidence that institutional activism, in combination with merger and acquisition activity, has become an important factor in disciplining underperforming managers.

**THE ROLE OF M&A IN ACHIEVING GOOD CORPORATE GOVERNANCE**

Changes in corporate control can occur because of a hostile (i.e., bids contested by the target’s board and management) or friendly takeover of a target firm, or because of a proxy contest initiated by dissident shareholders. When a firm’s internal mechanisms that govern management control are relatively weak, the corporate takeover market seems to act as a “court of last resort” to discipline inappropriate management behavior.\(^3\) Strong internal governance mechanisms, by contrast, lessen the role of a takeover threat as a disciplinary factor. Moreover, the disciplining effect of a takeover

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\(^3\) Kini, Kracaw, and Mian (2004).
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threat on a firm’s management can be reinforced when it is paired with a large shareholding by an institutional investor.4

There are several theories that explain why managers may resist a takeover attempt. The management entrenchment theory suggests managers use a variety of takeover defenses to ensure their longevity with the firm. Hostile takeovers, or the threat of such takeovers, have historically been useful for maintaining good corporate governance by removing bad managers and installing better ones.5 Indeed, there is evidence of frequent management turnover even if a takeover attempt is defeated because takeover targets are often poor financial performers.6 An alternative viewpoint is the shareholder interest theory, which suggests that management resistance to proposed takeovers is a good bargaining strategy to increase the purchase price to the benefit of the target firm’s shareholders.7

In a proxy contest, a dissident group of shareholders attempts to gain representation on a firm’s board of directors or change management proposals. Although those that address issues other than board representation do not bind a firm’s board of directors, there is evidence that boards are becoming more responsive—perhaps reflecting fallout from the Enron-type scandals in 2001 and 2002.8 Even unsuccessful proxy contests often lead to a change in management, a restructuring of the firm, or investor expectations that the firm ultimately will be acquired.

THE FRIENDLY APPROACH IN THE CORPORATE TAKEOVER MARKET

In friendly takeovers, a negotiated settlement is possible without the acquirer resorting to aggressive tactics. The potential acquirer initiates an informal dialogue with the target’s top management, and the acquirer and target reach agreement on key issues early in the process. Typically, these issues include the long-term business strategy of the combined firms, how they will operate in the short term, and who will be in key management positions. Often, a standstill agreement is negotiated in which the acquirer agrees not to make any further investments in the target’s stock for a

4 Cremers and Nair (2005).
5 Morck, Shleifer, and Vishny (1988b).
6 Economic Report to the President (2003, p. 81).
7 Franks and Mayer (1996); Schwert (2000).
8 According to Ertimur, Ferri, and Stubben (2008), boards implemented 41 percent of nonbinding shareholder proposals for majority voting in 2004, versus only 22 percent in 1997. A board was more likely to adopt a shareholder proposal if a competitor had adopted a similar plan.
stipulated period. This compels the acquirer to pursue the acquisition on friendly terms alone, at least for the period covered by the agreement. It also permits negotiations to proceed without the threat of more aggressive tactics, such as those discussed in the following sections.

THE HOSTILE APPROACH IN THE CORPORATE TAKEOVER MARKET

The 1970s and early 1980s were characterized by blitzkrieg-style takeovers. According to Thomson Reuters, hostile takeovers of U.S. firms peaked at about 14 percent of all takeovers in the 1980s before dropping to a low of about 4 percent in the 1990s. The decline can be attributed in part to the soaring stock market in the 1990s—target shareholders are more willing to accept takeover bids when their shares are overvalued. In addition, federal prenotification regulations have slowed dramatically a process that used to be quicker. When a firm acquires more than 5 percent of the stock of a publicly traded firm, it is required to file its intentions publicly with the SEC. A number of states and public stock exchanges also require shareholder approval for certain types of offers. Moreover, most large companies have antitakeover defenses in place, such as poison pills. Hostile takeover battles are now likely to last for months.

There are several types of hostile takeover tactics, including the bear hug, proxy contest, and tender offer.

The Bear Hug: Limiting the Target’s Options

With a bear hug, the acquirer mails a letter that includes an acquisition proposal to the target company’s CEO and board of directors. The letter arrives with no warning and demands a rapid decision. The bear hug usually involves a public announcement as well.

The aim is to move the board to a negotiated settlement. The board may be motivated to do so because of its fiduciary responsibility to the target’s shareholders. Directors who vote against the proposal may be subject to lawsuits from target stockholders. This is especially true if the offer is at a substantial premium to the target’s current stock price. Once the bid is made public, the company is effectively “put into play” (i.e., likely to attract additional bidders). Institutional investors and arbitrageurs add to the pressure by lobbying the board to accept the offer. Arbitrageurs (“arbs”) are likely to acquire the target’s stock and to sell the bidder’s stock short in an effort to profit from the anticipated rise in the target’s
share price and the fall in the acquirer’s share price. Short selling involves borrowing stock, selling it, and buying it back at what is expected to be a lower price. The accumulation of stock by arbs makes purchases of blocks of stock by the bidder easier because the arbs often are quite willing to sell their shares.

**Proxy Contests in Support of a Takeover**

There are three primary forms of the *proxy contest*. In one, dissident shareholders attempt to win representation on the board of directors. In another, they seek to change a firm’s bylaws or force management to take some particular action (e.g., dividend payments and share repurchases) by obtaining the right to vote on behalf of other shareholders. Finally, proxy contests may concern management proposals (e.g., an acquisition). Most commonly, dissidents initiate a proxy fight to remove management, due to poor corporate performance, or a desire to promote a specific type of restructuring of the firm (e.g., sell or spin off a business) or the outright sale of the business; or they do so to force a distribution of excess cash to shareholders.9

Proxy fights enable dissident shareholders to replace specific board members or management with those more willing to support their positions. By replacing board members, proxy contests can be an effective means of gaining control without owning 50.1 percent of the voting stock, or they can be used to eliminate takeover defenses, such as poison pills, as a precursor of a tender offer. For example, Weyerhauser succeeded in placing three directors on rival Willamette Industries’ nine-member board in 2001, and the prospect of losing an additional three seats the following year ultimately brought Willamette to the bargaining table and ended Weyerhauser’s 13-month takeover attempt. In mid-2005, billionaire Carl Icahn and his two dissident nominees won seats on the board of Blockbuster and ousted Chairman John Antioco.

Initiating a proxy contest to replace a board is costly, which explains why there are so few contested board elections.10 For the official slate of directors nominated by the board, campaigns can be paid out of corporate funds, but shareholders promoting their own slate of candidates must pay substantial fees to hire proxy solicitors, investment bankers, and attorneys. On top of this, they face other expenses to print and mail the proxy statement and place advertisements. Litigation expenses may also be substantial and can

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easily become the largest single cost in a highly contentious proxy contest. Nonetheless, a successful proxy fight is a far less expensive way to gain control over a target than a tender offer, which may require purchasing a controlling interest in the target at a substantial premium.

**Implementing a Proxy Contest**

When the bidder is also a shareholder in the target firm, the proxy process may begin with the bidder attempting to call a special stockholders’ meeting. Alternatively, the bidder may put a proposal to replace the board or management at a regularly scheduled stockholders’ meeting. Before the meeting, the bidder may open an aggressive public relations campaign, with direct solicitations sent to shareholders and full-page advertisements in the press to convince shareholders to support the bidder’s proposals. The target will respond with its own campaign and will have a distinct advantage in being able to deal directly with its own shareholders. The bidder may even have to sue the target corporation to get a list of its shareholders’ names and addresses. Often, shares are held in the names of banks or brokerage houses under “street names,” and these depositories generally do not have the authority to vote such shares.

When shareholders receive the proxies, they may choose to sign and send them directly to a designated collection point such as a brokerage house or bank. Shareholders may change their votes until they are counted—which often takes place under the strict supervision of inspectors to ensure accuracy. Both the target firm and bidder generally have their own proxy solicitors present during the tabulation process.

**Legal Filings in Undertaking Proxy Contests**

SEC regulations cover proxy solicitations under Section 14(A) of the Securities Exchange Act of 1934. All materials distributed to shareholders must be submitted to the SEC for review at least 10 days before they are distributed. The party attempting to solicit proxies from the target’s shareholders must file a *proxy statement* and Schedule 14A with the SEC and mail it to the target’s shareholders; these statements include the date of the shareholders, meeting at which approval of the transaction is to be solicited, details of the merger agreement, company backgrounds, reasons for the proposed merger, and opinions of legal and financial advisors. Proxy statements may be obtained from the companies involved and on the SEC’s website, and are excellent sources of information about a proposed transaction.

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11 [www.sec.gov](http://www.sec.gov)
The Impact of Proxy Contests on Shareholder Value

Only one-fifth to one-third of all proxy fights actually result in a change in board control. Despite this low success rate, there is some empirical evidence that proxy fights result in abnormal returns to shareholders of the target company regardless of the outcome.\textsuperscript{12} The reasons for these gains may include the eventual change in management at firms embroiled in proxy fights, the tendency for new management to restructure the firm, investor expectations of a future change in control due to M&A activity, and possible special cash payouts for firms with excess cash holdings.

The Hostile Tender Offer

A \textit{hostile tender offer} is a deliberate effort to go around the target’s board and management to reach the target’s shareholders directly with an offer to purchase their shares. Unlike a merger in which the minority must agree to the terms of the agreement negotiated by the board once the majority of the firm’s shareholders (i.e., 50.1 percent or more) approve the proposal, the tender offer specifically allows for the minority shareholders’ approval. In a traditional merger, minority shareholders are said to be frozen out of their positions. This majority approval requirement is intended to prevent minority shareholders from stopping a merger until they are paid a premium over the purchase price agreed to by the majority. Following the tender offer, the target firm becomes a partially owned subsidiary of the acquiring company.

Although target boards often discourage unwanted bids initially, they are more likely to relent when a hostile tender offer is initiated.\textsuperscript{13} While they have become more common in recent years, hostile takeovers are also rare outside the United States.

Pre-tender Offer Tactics: Purchasing Target Stock in the Open Market

Potential bidders often purchase stock in a target before a formal bid to accumulate stock at a price lower than the eventual offer price. Such purchases are normally kept secret to avoid driving up the price and increasing the average price paid for such shares. The primary advantage to the

\textsuperscript{12} In studies covering proxy contests during the 1980s through the mid-1990s, abnormal returns ranged from 6 to 19 percent, even if the dissident shareholders were unsuccessful in the proxy contest (DeAngelo and DeAngelo, 1989; Faley, 2004; and Mulherin and Poulsen, 1998).

\textsuperscript{13} In a study of 1,018 tender offers in the United States between 1962 and 2001, Bhagat et al. (2005) found that target boards resisted tender offers about one-fifth of the time. In a study of 49 countries, Rossi and Volpin (2004) found that only about 1 percent of 45,686 M&A transactions considered between 1990 and 2002 were opposed by target firm boards.
bidder of accumulating target stock before an offer is the potential leverage achieved with the voting rights associated with the stock it has purchased. This voting power is important in a proxy contest to remove takeover defenses, win shareholder approval under state antitakeover statutes, or elect members of the target’s board. In addition, the bidder can sell this stock later if the takeover attempt is unsuccessful.

After the bidder has established a toehold ownership position in the voting stock of the target through open-market purchases, the bidder may attempt to call a special stockholders’ meeting in an effort to replace the board of directors or remove takeover defenses. The conditions under which such a meeting can be called are determined by the firm’s articles of incorporation governed by the laws of the state in which the firm is incorporated.\(^\text{14}\)

**Implementing a Tender Offer**

Tender offers can be for cash, stock, debt, or some combination of the three. Unlike mergers, tender offers frequently use cash as the form of payment. Securities transactions involve a longer period to complete the takeover because new security issues must be registered with and approved by the SEC and because states have their own security registration requirements. During the approval period, target firms are able to prepare defenses and solicit other bids, resulting in a potentially higher purchase price for the target. If the tender offer involves a share-for-share exchange, it is referred to as an **exchange offer**. Whether cash or securities, the offer is made directly to target shareholders, is extended for a specific period, and may be unrestricted (any-or-all offer) or restricted to a certain percentage or number of the target’s shares.

Tender offers restricted to purchasing less than 100 percent of the target’s outstanding shares may be oversubscribed. Because the Williams Act of 1968 requires equal treatment of all shareholders tendering shares, the bidder may either purchase all of the target stock that is tendered or purchase only a portion of the tendered stock. For example, if the bidder has extended a tender offer for 70 percent of the target’s outstanding shares and 90 percent of the target’s stock actually is offered, the bidder may choose to prorate the purchase of stock by buying only 63 percent (i.e., \(0.7 \times 0.9\)) of the tendered stock from each shareholder.

\(^{14}\) A copy of a firm’s articles of incorporation can usually be obtained for a nominal fee from the Office of the Secretary of State of the state in which the firm is incorporated.
If the bidder chooses to revise the tender offer, the waiting period is automatically extended. If another bid is made to the target shareholders, the waiting period must also be extended by another 10 days to provide adequate time to consider the new bid. Once initiated, tender offers for publicly traded firms are usually successful, although the success rate is lower if it is contested.\textsuperscript{15}

\textit{Multitiered Offers}

The form of the bid for the target firm can be presented to target shareholders either as a one- or two-tiered offer. In a \textit{one-tier offer}, the acquirer announces the same offer to all target shareholders, which offers the potential to purchase control of the target quickly and thus discourage other potential bidders from attempting to disrupt the transaction.

In a \textit{two-tiered offer}, the acquirer offers to buy a certain number of shares at one price and more shares at a lower price at a later date. The form of payment in the second tier may also be less attractive, consisting of securities rather than cash. The intent of the two-tiered approach is to give target shareholders an incentive to tender their shares early in the process to receive the higher price.

Once the bidding firm accumulates enough shares to gain control of the target (usually 50.1 percent), the bidder may initiate a so-called \textit{back end merger} by calling a special shareholders’ meeting seeking approval for a merger in which minority shareholders are required to accede to the majority vote. Alternatively, the bidder may operate the target firm as a partially owned subsidiary, later merging it into a newly created wholly owned subsidiary.

Many state statutes have been amended to require equal treatment for all tendering shareholders as part of two-tier offers. Many states also give target shareholders \textit{appraisal rights} that allow those not tendering shares in the first or second tier to ask the state court to determine a “fair value” for the shares. The appraised value for the shares may be more or less than the offer made by the bidding firm. The minority shares may be subject to a “minority discount” because they are worth less to the bidder than those acquired in the process of gaining control. State statutes may also contain fair price provisions in which all target shareholders, including those in the second tier, receive the same price and redemption rights, enabling target

\textsuperscript{15} According to Mergerstat, the success rate of total attempted tender offers between 1980 and 2000 was more than 80 percent, with the success rate for uncontested offers more than 90 percent and for contested (i.e., by the target’s board) offers slightly more than 50 percent.
shareholders in the second tier to redeem their shares at a price similar to that paid in the first tier.

An acquirer seeking a controlling interest in the target firm may initiate a *creeping takeover strategy*, which involves purchasing target voting stock in relatively small increments until the acquirer has gained effective control of the firm. This may occur at less than 50.1 percent if the target firm’s ownership is widely dispersed. If about 60 percent of a firm’s eligible shareholders vote in elections for directors, a minority owning as little as 35 percent can elect its own slate of directors. Acquirers generally will pay more for the initial voting shares than for shares acquired later.

There are a number of disadvantages to owning less than 100 percent of the target’s voting stock. They include the potential for dissident minority shareholders to disrupt efforts to implement important management decisions, the cost incurred in providing financial statements to both majority and minority shareholders, and current accounting and tax rules. Owning less than 50.1 percent means that the target cannot be consolidated for purposes of financial reporting but instead must be accounted for using the equity method. Because the equity method will include the investor’s share of the target’s income, it will not change consolidated income; however, the target’s assets, liabilities, revenues, and expenses are not shown on the investor’s financial statements. Consequently, potential increases in borrowing capacity from showing a larger asset or sales base would not be realized. Furthermore, target losses cannot be used to offset bidder gains because consolidation for tax purposes requires owning 80.1 percent of the target.

**Legal Filings in Undertaking Tender Offers**

Federal securities laws impose a number of reporting, disclosure, and anti-fraud requirements on acquirers initiating tender offers. After the tender offer has been made, the acquirer cannot purchase any target shares other than the number specified in the tender offer. Section 14(D) of the Williams Act requires that any individual or entity making a tender offer resulting in owning more than 5 percent of any class of equity must file a Schedule 14D-1 and all solicitation materials with the SEC.

**After the Tender Offer**

Following the tender offer, the target firm becomes a partially owned subsidiary of the acquiring company. In some instances, the terms of the transaction may be *crammed down* or imposed on the minority. This is
achieved by the parent firm merging the partially owned subsidiary that resulted from the failure of the tender offer to get substantially all of the target firm’s shares into a new wholly owned subsidiary. Alternatively, the acquirer may decide not to acquire 100 percent of the target’s stock—in which case the minority is subject to a freeze-out or squeeze-out that makes the remaining shareholders dependent on the decisions made by the majority shareholders.

**Advantages of the Hostile Takeover**

Although hostile takeovers today are certainly more challenging than in the past, they have certain advantages over the friendly approach. One is that the friendly approach surrenders the element of surprise. Even a few days’ warning gives the target’s management time to take defensive action to impede the actions of the suitor. Negotiation also raises the likelihood of a leak and a spike in the price of the target’s stock as arbs seek to profit from the spread between the offer price and the target’s current stock price. The speculative increase in the target’s share price can add dramatically to the cost of the transaction: the initial offer by the bidder generally includes a premium over the target’s current share price, and because that premium usually is expressed as a percentage of the target’s share price, a speculative increase in the target firm’s current share price will add to the overall purchase price paid by the acquiring firm. For these reasons, a bidder may opt for a more hostile approach.

The early successes of the hostile tender offer generated new, more effective defenses. Takeover tactics had to adapt to the proliferation of more formidable defenses. For example, hostile tender offers were used in the 1990s in combination with proxy contests to coerce target boards into rescinding takeover defenses.

**WHAT MAKES THE AGGRESSIVE APPROACH SUCCESSFUL?**

Successful hostile takeovers depend on the premium offered to target shareholders; the board’s composition; and the composition, sentiment, and investment horizon of the target’s current shareholders. Other factors include the provisions of the target’s bylaws and the potential for the target to implement additional takeover defenses.

The target’s board will find it more difficult to reject offers exhibiting substantial premiums to the target’s current stock price. Concern about its fiduciary responsibility and possible stockholder lawsuits put pressure
on the target’s board to accept the offer. Despite the pressure of an attractive premium, the composition of the target’s board also greatly influences what the board does and the timing of its decisions. A board dominated by independent directors, nonemployees, or family members is more likely to resist offers in an effort to induce the bidder to raise the offer price or to gain time to solicit competing bids than to protect itself and current management.\textsuperscript{16}

Furthermore, the final outcome of a hostile takeover is heavily dependent on the composition of the target’s stock ownership, how stockholders feel about management’s performance, and how long they intend to hold the stock. Firms held predominantly by short-term investors (i.e., less than four months) are more likely to receive a bid and exhibit a lower average premium of as much as 3 percent when acquired, and researchers speculate that firms held by short-term investors have a weaker bargaining position with the bidder.\textsuperscript{17} To assess these factors, an acquirer compiles (to the extent possible) lists of stock ownership by category: management, officers, employees, and institutions such as pension and mutual funds. This information can be used to estimate the target’s float—the number of shares that are outstanding, not held by block shareholders, and available for trading by the public. The larger the share of stock held by corporate officers, family members, and employees, the smaller the float, because these types of shareholders are less likely to sell their shares. Float is likely to be largest for those companies in which shareholders are disappointed with the firm’s financial performance.

Finally, an astute bidder will always analyze the target firm’s bylaws (often easily accessible through a firm’s website) for provisions potentially adding to the cost of a takeover. Such provisions could include a staggered board, the inability to remove directors without cause, or super-majority voting requirements for approval of mergers. These and other measures are detailed in Chapter 4.

\textbf{OTHER TACTICAL CONSIDERATIONS}

The average time between signing the initial agreement and completing or terminating an agreement is about six months, which gives both buyer

\textsuperscript{16} The shareholder gain from the inception of the offer to its resolution is 62.3 percent for targets with an independent board, as compared with 40.9 percent for targets without an independent board (Shivdasani, 1993).

\textsuperscript{17} Gaspara and Matos (2005).
and seller an incentive to hold up a deal to renegotiate the terms based on new information. Several strategies have been designed to minimize this so-called hold-up problem.

To heighten the chance of a successful takeover, the bidder will include a variety of provisions in a letter of intent (LOI) designed to discourage the target firm from backing out of any preliminary agreements. The LOI is a preliminary agreement between two companies intending to merge that stipulates major areas of agreement between the parties, as well as their rights and limitations. It may contain a number of features that protect the buyer; among the most common is the no-shop agreement, which prohibits the takeover target from seeking other bids or making public information not currently and readily available. Related agreements commit the target firm’s management to use its best efforts to secure shareholder approval of the bidder’s offer.

Contracts often grant the target the right to forgo the merger and pursue an alternative strategy and the acquirer the right to withdraw from the agreement. However, the right to break the agreement is usually not free. A breakup fee or termination fee is paid to the initial bidder or target if the transaction is not completed, and includes legal and advisory expenses, executive management time, and the costs associated with opportunities that may have been lost to the bidder who was involved in trying to close this deal.\(^\text{18}\)

Termination fees are used more frequently on the target side than on that of the acquirer because targets have greater incentives to break contracts and seek other bidders. Such fees tend to average about 3 percent of the purchase price, and using them increases the probability of a deal being completed.\(^\text{19}\)

A breakup fee paid by the bidder to the target firm is called a reverse breakup fee, and such fees have become more common in recent years as buyers, finding it increasingly difficult to finance transactions, have opted to back out of signed agreements. Pharmaceutical behemoth Pfizer’s 2009 agreement of purchase and sale to buy Wyeth contained a reverse termination fee in which Pfizer could withdraw from the contract only if it received a credit rating downgrade and its lenders refused to extend loans based on the downgrade. Had this happened, Pfizer would have been legally bound to pay Wyeth a $4.5 billion payment equal to an eye-popping 6.6 percent of the $68 billion purchase price.

\(^\text{18}\) In a sample of 1,100 stock mergers between 1994 and 1999, Hotchkiss, Qian, and Song (2004) found a target termination or breakup fee included in the initial agreement in 55 percent of all deals, whereas in 21 percent of the deals both target and acquirer termination fees were included.

\(^\text{19}\) Officer (2003).
The stock lockup, an option granted to the bidder to buy the target firm’s stock at that bidder’s initial offer, is another form of protection for the bidder. It is triggered whenever the target firm accepts a competing bid. Because the target may choose to sell to a higher bidder, the stock lockup arrangement usually ensures that the initial bidder will make a profit on its purchase of the target’s stock. The initial bidder also may require that the seller agree to a crown jewels lockup, in which the initial bidder has an option to buy important strategic assets of the seller, if the seller chooses to sell to another party. Target firms may use lockup options to enhance their bargaining power in dealing with a bidding firm.  

**DEVELOPING A BIDDING OR TAKEOVER STRATEGY**

The tactics that may be used in developing a bidding strategy should be viewed as a series of decision points, with objectives and options usually well defined and understood before a takeover attempt is initiated. Preoffer planning should involve a review of the target’s current defenses, an assessment of the defenses that could be put in place by the target after an offer is made, and the size of the float associated with the target’s stock. Poor planning can result in poor bidding, which can be costly to CEOs—they may lose their jobs.

Common bidding strategy objectives include winning control of the target, minimizing the control premium, minimizing transaction costs, and facilitating postacquisition integration. If minimizing the cost of the purchase (i.e., the price paid to purchase the target firm) and transaction costs, while maximizing cooperation between the two parties, is considered critical, the bidder may choose the “friendly” approach, which has the advantage of generally being less costly than more aggressive tactics and minimizes the loss of key personnel, customers, and suppliers during the fight for control of the target. Friendly takeovers avoid an auction environment, which may raise the target’s purchase price. Moreover, friendly acquisitions facilitate premerger integration planning and increase

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21 Lehn and Zhao (2006), for a sample of 714 acquisitions between 1990 and 1998, found that 47 percent of acquiring firm CEOs were replaced within five years. Moreover, top executives are more likely to be replaced at firms that have made poor acquisitions sometime during the previous five years.
the likelihood that the combined businesses will be quickly integrated following closing.

As described earlier, the primary risk of the friendly approach is the loss of surprise. If the target is unwilling to reach a negotiated settlement, the acquirer is faced with the choice of abandoning the effort or resorting to more aggressive tactics. Such tactics are likely to be less effective because of the extra time they give the target’s management to put additional takeover defenses in place. In reality, the risk of loss of surprise may not be very great because of the prenotification requirements of current U.S. law.

The bidder initiates contact casually through an intermediary or through a more formal inquiry (see Exhibit 3–2, reading from left to right). If the target’s management and board reject the bidder’s initial offer, the bidder’s options under the friendly approach are either to walk away or adopt more aggressive tactics. In the latter case, the bidder may undertake a simple bear hug, hoping that pressure from large institutional shareholders and arbs will nudge the target toward a negotiated settlement.

If the bear hug fails to convince the target’s management to negotiate, the bidder may choose to buy stock in the open market. This is most effective when ownership in the target is concentrated among relatively few shareholders. The bidder may accumulate a sufficient number of voting rights to call a special stockholders’ meeting if a proxy fight is deemed necessary to change board members or dismember the target’s defenses.

If the target’s defenses are viewed as relatively weak, the bidder may forgo a proxy contest and initiate a tender offer for the target’s stock. If the target’s defenses appear formidable, however, the bidder may implement a proxy contest and a tender offer concurrently. That, however, is a very expensive strategy. Tender offers are costly, because they are offers to buy up to 100 percent of the target’s outstanding stock at a significant premium. A proxy fight, although less expensive, is still costly, involving all the fees described earlier—including for extensive litigation, which is likely.

Litigation is a common tactic used to pressure the target board to relent to the bidder’s proposal or remove defenses. It is most effective if the firm’s defenses appear to be especially onerous. The bidder may initiate litigation that accuses the target’s board of not giving the bidder’s offer sufficient review, or may argue that the target’s defenses are not in the best interests of the target’s shareholders and serve only to entrench senior management. In such a case, the acquirer will allege that the board is violating its fiduciary responsibility to the target shareholders.
EXHIBIT 3-2  Alternative Takeover Tactics

- Bidder Adopts Friendly Approach to Target’s Board
  - Initial Query/Casual Pass
    - Target Board’s Response
      - If Yes, Proceed to Negotiated Settlement
      - If No, Walk Away
- Bidder Adopts more Aggressive Approach to Target’s Board
  - Bear Hug (A)
    - Target Board’s Response
      - If Yes, Proceed to Negotiated Settlement
      - If No, Initiate
        - Proxy Fight
        - Open Market Purchases
        - Tender Offer
        - Tender Offer & Proxy Fight
          - Proxy Fight (B)
          - Open Mkt. Purchase (C)
          - Tender Offer (D)
          - Litigation (E)
            - Target Response
              - If Yes, Rescind Tender Offer & Proceed to Negotiated Settlement
              - If No, Implement Tender Offer
## EXHIBIT 3-3  Advantages and Disadvantages of Alternative Takeover Tactics

**Common Bidder Strategy Objectives:**
- Gain control of target firm
- Minimize the size of the control premium
- Minimize transaction costs
- Facilitate postacquisition integration

<table>
<thead>
<tr>
<th>Tactics</th>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
</table>
| Casual Pass (i.e., informal inquiry) | • May learn target is receptive to offer  
• Raises pressure on target to negotiate a deal | • Gives advance warning  
• Gives advance warning |
| Bear Hug (i.e., letter to target board forcefully proposing takeover) | • May lower cost of transaction  
• Creates profit if target agrees to buy back bidder's toehold position (i.e., greenmail)  
• May discourage other bidders | • Can result in a less-than-controlling interest  
• Limits on amount can purchase without disclosure  
• Some shareholders could hold out for higher price  
• Could suffer losses if takeover attempt fails |
| Open-Market Purchases (i.e., acquirer buys target shares on public markets) | • Less expensive than tender offer  
• May obviate need for tender offer  
• Pressures target shareholders to sell stock  
• Bidder not bound to purchase tendered shares unless desired number of shares tendered | • Relatively low probability of success if target stock widely held  
• Adds to transaction costs  
• Tends to be most expensive tactic  
• Disruptive to postclosing integration due to potential loss of key target management, customers, and suppliers |
| Proxy Contest (i.e., effort to obtain target shareholder support to change target board) | • Less expensive than tender offer  
• May obviate need for tender offer  
• Pressures target shareholders to sell stock  
• Bidder not bound to purchase tendered shares unless desired number of shares tendered | • Relatively low probability of success if target stock widely held  
• Adds to transaction costs  
• Tends to be most expensive tactic  
• Disruptive to postclosing integration due to potential loss of key target management, customers, and suppliers |
| Tender Offer (i.e., direct offer to target shareholders to buy shares) | • Litigation (i.e., lawsuits accusing target board of improper conduct) | • Expense |
| • Puts pressure on target board | • Expense |
Exhibit 3-3 summarizes common bidder objectives and the advantages and disadvantages of the various tactics that may be employed to achieve these objectives.

***

In a free market economy, the corporate takeover market in which takeover tactics and defenses are employed facilitates the allocation of resources and disciplines underperforming managers. This market, along with federal and state legislation, the courts, regulators, and institutional activism, help promote good corporate governance practices that protect stakeholder interests.

A Case in Point: Mittal Acquires Arcelor in a Battle of Global Titans

Ending five months of maneuvering, Arcelor—created in 2001 by a combination of steel companies in Spain, France, and Luxembourg—agreed on June 26, 2006, to be acquired by larger rival Mittal Steel Co. for $33.8 billion in cash and stock. Mittal is headquartered in the Netherlands and has plants outside Europe where labor costs are lower. Mittal acquired Arcelor to accelerate steel industry consolidation and reduce industry overcapacity. The combined firms could have more leverage in setting prices and negotiating contracts with major customers such as auto and appliance manufacturers and suppliers such as iron ore and coal vendors; in addition, they could eventually realize $1 billion annually in pretax cost savings.

The takeover battle was one of the most acrimonious in recent European Union history. It shows how far a firm can go in an attempt to halt an unwanted takeover.

Mittal first tried to consummate a friendly merger but was rebuffed by Arcelor’s president. Then, in January 2006, Mittal launched a tender offer, mostly of stock and cash, for all of Arcelor’s outstanding equity at a 27 percent premium over the share price at the time. Arcelor’s management, European trade unions (fearing job losses), and government officials reacted swiftly and furiously.

Arcelor’s president then undertook one of the most aggressive takeover defenses in recent corporate history. Early that February, Arcelor doubled its dividend and announced plans to buy back about $8.75 billion in stock at a price well above the then-current market price for Arcelor stock—aimed at motivating Arcelor shareholders not to tender their shares to Mittal. Arcelor also backed an unsuccessful move to change the law to require Mittal to pay in cash.

To counter these moves, Mittal Steel announced that if it received more than one-half of the Arcelor shares submitted in the initial tender offer, it would hold a second tender offer for the remaining shares at a slightly lower price.
Mittal pointed out that it could acquire the remaining shares through a merger or corporate reorganization. This rhetoric sought to encourage Arcelor shareholders to tender their shares during the first offer.

A host of other defensive steps were then taken. In April, Arcelor completed a deal initiated in 2005 to buy Canadian steelmaker Dofasco for $5 billion and then set up a special Dutch trust to prevent Mittal from getting access to the asset, which Mittal was proposing to sell to raise money and avoid North American antitrust concerns. Mittal immediately sued to test the legality of this tactic. Arcelor also cut a deal to exchange a 32 percent stake in Arcelor for the 90 percent stake held by a Mr. Alexei Mordashov in the Russian steelmaker OAO Severstahl and then scheduled an unusual vote that created very tough conditions for Arcelor shareholders to prevent the deal from being completed. Some major Arcelor shareholders balked, and the Arcelor board was pressured to at least agree to talk to Mittal. When Arcelor first demanded and received an intricate business plan from Mittal, Arcelor still refused to talk.

In late May, Mittal raised its bid by 34 percent and said that if the bid succeeded, Mittal would eliminate its two-tiered share structure, which gave the Mittal family shares 10 times the voting rights of other shareholders. The Arcelor board rejected Mittal’s sweetened bid and repeated its support of the Severstahl deal. Shareholder anger continued as many investors said they would reject the share buyback, some because it would increase Mordashov’s ultimate stake in Arcelor to 38 percent by reducing the number of outstanding Arcelor shares—and thus give Mordashov “effective control” of the company under the law of most European countries.

Arcelor canceled a scheduled June 21 shareholder vote on the buyback and then—despite Mordashov’s efforts to enhance his bid—the Arcelor board asked him and Mittal to submit final bids by June 25.

Finally, Arcelor agreed to Mittal’s final bid. The new offer was $15.70 in cash and 1.0833 Mittal shares for each Arcelor share, valued at $50.54 per Arcelor share, up from Mittal’s initial bid in January 2006 of $35.26. This final offer represented an unprecedented 93 percent premium over Arcelor’s share price of $26.25 immediately before Mittal’s initial bid. Lakshmi Mittal would control 43.5 percent of the combined firm’s stock, and Mordashov would receive a $175 million breakup fee for Arcelor’s failure to complete its agreement with him. Finally, Mittal agreed not to make any layoffs beyond what Arcelor already had planned.

**Things to Think About:**

1. Identify the takeover tactics employed by Mittal and explain why each was used.
2. Identify the takeover defenses employed by Arcelor and explain why each was used.
3. Using the Arcelor/Mittal example, discuss the arguments for and against encouraging hostile corporate takeovers.

4. Was Arcelor’s board and management acting to protect their own positions (i.e., the management entrenchment theory) or in the best interests of the shareholders (i.e., the shareholder interests theory)? Explain your answer.

5. In an attempt to counter Mittal’s hostile tender offer, Arcelor offered to increase its dividend and to buy back shares from current shareholders. In doing so, it hoped to discourage Arcelor shareholders from tendering their shares to Mittal. Explain how you, as an Arcelor shareholder, would decide whether to tender your shares to Mittal or support Arcelor’s management.

Answers can be found at:
CHAPTER 4

Common Takeover Defenses

You learned in Chapter 3 about the tactics acquirers commonly use to gain a controlling interest in a target firm. This chapter focuses on the defense.

Takeover defenses are impediments to potential bidders and are designed either to slow down an unwanted offer or force a suitor to raise the bid to get the target’s board to rescind the defense. Some observers argue that these defenses are meant to discourage unwanted takeovers so target management can hold on to high salaries and perks. Others contend that these defenses often benefit shareholders by forcing bidders to raise their offer prices.

Takeover defenses are designed either to slow the takeover process and give the target firm a chance to strengthen its existing defense or put new ones in place, or raise the total cost to the acquirers of taking over the target. They can be grouped in two categories: those put in place before receiving an offer and those implemented after receipt of an offer. Exhibit 4-1 shows the most commonly used pre- and post-offer defenses; public companies use, on average, three of these when confronted with a takeover attempt.1 As you will learn in this chapter, they are effective to varying degrees.

The best defense against unwanted suitors may be advance planning and a strong financial performance. Large public companies routinely review their takeover defenses. Many companies have “stock watch” programs in place that are intended to identify stock accumulations, or stock price movements that reflect an impending takeover attempt. Such programs track trading patterns in a company’s stock. Companies require their stock transfer agent to provide up-to-date and accurate stock transfer sheets and to report any unusual movements in stock transfer activity. Stock watch programs routinely review SEC records for any Schedule 13D filings, which are required when a firm buys more than 5 percent of another firm’s stock.

PRE-OFFER DEFENSES

Pre–offer defenses are used to prevent a sudden, unexpected hostile bid from gaining control of the company before management has time to

1 Field and Karpoff (2000).
## EXHIBIT 4-1 Alternative Pre-offer and Post-offer Takeover Defenses

<table>
<thead>
<tr>
<th>Pre-offer Defenses</th>
<th>Post-offer Defenses</th>
</tr>
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<tbody>
<tr>
<td>Poison Pills*:</td>
<td>Greenmail (Bidder’s investment purchased at a premium to what it paid as inducement to refrain from any further activity)</td>
</tr>
<tr>
<td>Flip-Over Rights Plans</td>
<td>Standstill Agreements (Often used in conjunction with an agreement to buy bidder’s investment)</td>
</tr>
<tr>
<td>Flip-In Rights Plans</td>
<td></td>
</tr>
<tr>
<td>Shark Repellants (Implemented by changing bylaws or charter):</td>
<td></td>
</tr>
<tr>
<td>Strengthening the Board’s Defenses</td>
<td></td>
</tr>
<tr>
<td>Staggered or Classified Board Elections</td>
<td></td>
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<tr>
<td>Cumulative Voting Rights</td>
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<tr>
<td>“For Cause” Provisions</td>
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<tr>
<td>Limiting Shareholder Actions</td>
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<tr>
<td>Calling Special Meetings</td>
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<tr>
<td>Consent Solicitations</td>
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<tr>
<td>Advance Notice Provisions</td>
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<tr>
<td>Super-Majority Rules</td>
<td></td>
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<tr>
<td>Other Shark Repellents</td>
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<tr>
<td>Antigreenmail Provisions</td>
<td></td>
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<tr>
<td>(Discourages target’s use of greenmail as a takeover tactic)</td>
<td></td>
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<tr>
<td>Fair Price Provisions</td>
<td></td>
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<tr>
<td>Supervoting Stock</td>
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<tr>
<td>Reincorporation</td>
<td></td>
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<tr>
<td>Golden Parachutes</td>
<td>Pac-Man Defense</td>
</tr>
<tr>
<td>White Knights and White Squires</td>
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<tr>
<td>Employee Stock Ownership Plans</td>
<td></td>
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<tr>
<td>Leveraged Recapitalization</td>
<td></td>
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<tr>
<td>Share Repurchase or Buyback Plans</td>
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<tr>
<td>Corporate Restructuring</td>
<td></td>
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<tr>
<td>Litigation</td>
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</tbody>
</table>

*Although many different types of poison pills are used, only the most common forms are discussed in this text.
Note also that the distinction between pre- and post-offer defenses is becoming murky as increasingly poison pill plans are put in place immediately following the announcement of a bid. Pills can be adopted without a shareholder vote because they are issued as a dividend and the board has the exclusive authority to issue dividends.
assess their options properly. If the pre-offer defenses succeed in delaying the change in control, the target firm has time to erect additional defenses after the unsolicited offer is received.

Pre-offer defenses generally fall into three categories: poison pills, shark repellents, and golden parachutes. The sophistication of such measures has increased dramatically since 1980, keeping tempo with the growing effectiveness of takeover tactics.

**Poison Pills**

The popular press uses the term “poison pill” to describe a range of protections against unsolicited tender offers. In practice, however, the *poison pill* is a very specific type of antitakeover defense.

Often referred to as shareholder rights plans, poison pills are a new class of securities issued by a company to its shareholders. Because pills are issued as a dividend and the board has the exclusive authority to issue dividends, a pill can often be adopted without a shareholder vote (unless the firm’s bylaws limit such action). Consequently, poison pills can be adopted not only before but also after the onset of a hostile bid, which means that even a company that does not have a poison pill in place can be regarded as having a “shadow poison pill” that could be used in the event of a hostile bid.\(^2\)

Poison pill securities have no value unless an investor acquires a specific percentage (often as low as 10 percent) of the target firm’s voting stock. If this threshold percentage is exceeded and the pill is a so-called *flip-in poison pill*, the poison pill securities are activated and typically allow existing target shareholders to purchase additional shares of the target firm’s common stock at a discount from the current market price. Alternatively, if the pill is a *flip-over poison pill*, existing shareholders may purchase additional shares of the acquirer or surviving firm’s common shares (i.e., the shares of the combined companies), also at a discount.

Triggering the flip-in pill increases the acquirer’s cost of the transaction by increasing the number of target shares that need to be purchased for cash in a cash-for-share exchange or the number of new shares that must be issued by the acquirer in a share-for-share exchange. In a cash-for-share exchange, the change in the acquirer’s cash outlay will depend on the number of target shareholders exercising their right to buy additional target shares. For example, if the number of target shares outstanding doubled and the price per share offered by the acquirer remained unchanged, the

\(^2\) Coates (2000). According to sharkrepellent.com, almost one-fourth of first-time pill adoptions in 2007 were implemented when the firm was “in play.” This compares to about 3 percent of all first-time pill adoptions in 2002.
amount of cash required to buy all or a specific portion of the target’s shares would double. In a share-for-share exchange, the increased number of acquirer shares issued imposes a cost on acquirer shareholders by diluting their ownership position. News Corp. was using the flip-in poison pill when the firm announced on November 8, 2004, that it would give its shareholders the right to buy one share at half price for each share they own in the event any party seeks to buy a 15 percent stake in the firm. The pill would exclude the purchaser of the 15 percent stake.

**Exhibit 4-2** illustrates the dilution of the acquirer’s shareholders ownership position resulting from a poison pill in a share-for-share exchange offer. Assume the acquirer has 1 million shares currently outstanding and has agreed to acquire the 1 million shares of target stock outstanding by exchanging one share of acquirer stock for each share of target stock. To complete the transaction, the acquirer must issue 1 million shares of new stock, with the target’s stock being canceled. The total number of shares outstanding for the new company would be 2 million shares (i.e., 1 million of existing acquirer stock plus 1 million in newly issued shares). Target company and acquirer shareholders would each own one half of the new company. However, if target company shareholders were able to buy 1 million new shares of target stock at a nominal price because of a flip-in pill, the number of shares that now must be acquired would total 2 million. The total number of shares of the new company would be 3 million, of which target company shareholders would own two-thirds and acquirer shareholders one-third.

Note that a flip-in or flip-over pill has the same dilutive effect on acquirer shareholders. With the flip-in pill, target shareholders purchased 1 million new shares of target stock, whereas for a flip-over pill they bought 1 million new shares of the acquirer’s or surviving firm’s shares. In either case, the acquirer had to issue 1 million new shares.

Proponents of the pill defense argue that it prevents a raider from acquiring a substantial portion of the firm’s stock without board permission. Because the board generally has the power to rescind the pill, bidders are compelled to negotiate with the target’s board, which could result in a higher offer price. Pill defenses may be most effective when used with staggered board defenses in which a raider would be unable to remove the pill without winning two successive elections; this increases the likelihood of remaining independent. Detractors argue that pill defenses simply

\[^3\] According to Bebchuk et al. (2002), the likelihood of remaining independent rises from 34 to 61 percent with such a combination of defenses, and the probability that the first bidder will be successful drops from 34 to 14 percent.
### EXHIBIT 4-2 Acquirer Shareholder Dilution Due to Poison Pill

<table>
<thead>
<tr>
<th></th>
<th>New Company Shares Outstanding</th>
<th>Ownership Distribution in New Company (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Without Pill</td>
<td>With Pill</td>
</tr>
<tr>
<td><strong>Target Firm Shareholders</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Shares Currently Outstanding</td>
<td>1,000,000</td>
<td>2,000,000</td>
</tr>
<tr>
<td>Total Shares Outstanding</td>
<td>1,000,000</td>
<td>2,000,000</td>
</tr>
<tr>
<td><strong>Acquiring Firm Shareholders</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Shares Currently Outstanding</td>
<td>1,000,000</td>
<td>1,000,000</td>
</tr>
<tr>
<td>New Shares Issued</td>
<td>1,000,000</td>
<td>2,000,000</td>
</tr>
<tr>
<td>Total Shares Outstanding</td>
<td>2,000,000</td>
<td>3,000,000</td>
</tr>
</tbody>
</table>

### Flip-Over Pill Defense^4

|                       |                         |                                          |              |           |
| **Target Firm Shareholders** |                         |                                          |              |           |
| Shares Currently Outstanding | 1,000,000               | 1,000,000                                | 50           | 67        |
| Total Shares Outstanding     | 1,000,000               | 1,000,000                                |              |           |
| **Acquiring Firm Shareholders** |                         |                                          |              |           |
| Shares Currently Outstanding | 1,000,000               | 1,000,000                                | 50           | 33        |
| New Shares Issued          | 1,000,000               | 2,000,000                                |              |           |
| Total Shares Outstanding   | 2,000,000               | 3,000,000                                |              |           |

---

^1 Acquirer agrees to exchange one share of acquirer stock for each share of target stock. The target shares outstanding are canceled.

^2 Poison pill provisions enable target shareholders to buy one share of target stock for each share they own at a nominal price.

^3 2,000,000/3,000,000.

^4 One million new shares must be issued to target shareholders exercising their right to buy shares in the surviving or new company at a nominal price.
serve to entrench management and encourage disaffected shareholders to litigate.

In recent years, boards have been under pressure to require shareholder approval of all rights plans and rescind existing pill defenses.

**Shark Repellents**

*Shark repellents* are specific types of takeover defenses achieved by amending either a *corporate charter* or the *corporate bylaws*. The corporate charter gives the corporation its legal existence and comprises the *articles of incorporation*, a document filed with a state government by the founders of a corporation, and a *certificate of incorporation*, a document received from the state after the articles have been approved. The charter identifies the corporation’s name, purpose, number of authorized shares, and number and identity of directors. The corporation’s powers thus derive from the laws of the state and from the provisions of the charter. Rules governing the internal management of the corporation are described in the corporation’s bylaws, which are determined by the corporation’s founders.

Shark repellents are put in place largely to reinforce the ability of a firm’s board of directors to retain control. They predate poison pills as a defense, and their success in slowing down takeovers and making them more expensive has been mixed—which, in fact, partly explains why the poison pill and other more creative defenses were developed.

Today, shark repellents have largely become supplements to poison pill defenses. Their primary role is to make it more difficult to gain control of the board through a proxy fight at an annual or special meeting. In practice, shark repellents as described here require amendments to the firm’s charter, which necessitate a shareholder vote. Although there are many variations of shark repellents, the most typical are staggered board elections, restrictions on shareholder actions, antigreenmail provisions, super-voting, and debt-based defenses. *Exhibit 4–3* summarizes the primary advantages and disadvantages of each type of shark repellent defense in three categories: those that strengthen the board’s defenses, those that limit shareholder actions, and all others. The exhibit also includes poison pills and golden parachutes (detailed later in this chapter).

**Strengthening the Board’s Defenses**

A *staggered board election* or *classified board election* involves dividing the firm’s directors into a number of different classes. Only one class is up for reelection each year. For example, a 12-member board may have directors
### EXHIBIT 4-3  Advantages and Disadvantages of Pre-offer Takeover Defenses: Poison Pills, Shark Repellents, and Golden Parachutes

<table>
<thead>
<tr>
<th>Type of Defense</th>
<th>Advantages for Target Firm</th>
<th>Disadvantages for Target Firm</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Poison Pills: Raising the Cost of Acquisition</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
| Flip-Over Pills (Rights to buy stock in the acquirer, activated with 100% change in ownership) | Dilutes ownership position of current acquirer shareholders  
Rights redeemable by buying them back from shareholders at nominal price | Ineffective in preventing acquisition of <100% of target (Bidders could buy controlling interest only and buy remainder after rights expire)  
Subject to hostile tender contingent on target board’s redemption of pill  
Makes issuer less attractive to white knights |
| Flip-In Pills (Rights to buy stock in the target, activated when acquirer purchases <100% change in ownership) | Dilutes target stock regardless of amount purchased by potential acquirer  
Discriminatory as not given to investor who activated the rights  
Rights redeemable at any point prior to triggering event | Not permissible in some states due to discriminatory nature  
No poison pill provides any protection against proxy contests |

**Shark Repellents: Strengthening the Board’s Defenses**

<table>
<thead>
<tr>
<th>Type of Defense</th>
<th>Advantages for Target Firm</th>
<th>Disadvantages for Target Firm</th>
</tr>
</thead>
</table>
| Staggered or Classified Boards   | Delays assumption of control by a majority shareholder  
May be circumvented by increasing size of board, unless prevented by charter or bylaws |                                                                                             |
| Cumulative Voting                | Delays assumption of control by a majority shareholder  
Gives dissident shareholder a board seat and access to confidential information |                                                                                             |

*(Continued)*
### EXHIBIT 4-3 (Continued)

<table>
<thead>
<tr>
<th>Type of Defense</th>
<th>Advantages for Target Firm</th>
<th>Disadvantages for Target Firm</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Shark Repellents: Strengthening the Board’s Defenses</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Limitations on When Shareholders Can Remove Directors</td>
<td>“For cause” provisions narrow range of reasons for removal</td>
<td>Can be circumvented unless supported by a super-majority requirement for repeal</td>
</tr>
<tr>
<td><strong>Shark Repellents: Limiting Shareholder Actions</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Limitations on Calling Special Meetings</td>
<td>Limits ability to use special meetings to add board seats and remove or elect new members</td>
<td>States may require a special meeting if a certain percentage of shareholders request a meeting</td>
</tr>
<tr>
<td>Limiting Consent Solicitations</td>
<td>Limits ability of dissident shareholders to expedite a proxy contest process</td>
<td>May be subject to court challenge</td>
</tr>
<tr>
<td>Advance Notice Provisions</td>
<td>Gives board time to select its own slate of candidates and to decide an appropriate response</td>
<td>May be subject to court challenge</td>
</tr>
<tr>
<td>Super-Majority Provisions</td>
<td>May be applied selectively to events such as hostile takeovers</td>
<td>Can be circumvented unless a super-majority of shareholders are required to change the provision</td>
</tr>
<tr>
<td><strong>Other Shark Repellents</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Antigreenmail Provision</td>
<td>Eliminates profit opportunity for raiders</td>
<td>Eliminates greenmail as a takeover defense</td>
</tr>
<tr>
<td>Fair Price Provisions</td>
<td>Increases the cost of a two-tiered tender offer</td>
<td>Raises the cost to a white knight, unless waived by typically 95% of shareholders</td>
</tr>
</tbody>
</table>
In the first year, the three directors in what might be called “Class 1” are up for election; in the second year, “Class 2” directors are up for election; and so on. This means that an insurgent stockholder, even one who holds the majority of the stock, would have to wait for three election cycles to gain control of the board. Moreover, the size of the board is limited by the firm’s bylaws to preclude the insurgent stockholder from adding board seats to take control of the board. The target may have to accede to the majority stockholder’s demands because of litigation initiated by dissident shareholder groups. The likelihood of litigation is highest, and pressure on

<table>
<thead>
<tr>
<th>Type of Defense</th>
<th>Advantages for Target Firm</th>
<th>Disadvantages for Target Firm</th>
</tr>
</thead>
<tbody>
<tr>
<td>Supervoting Stock</td>
<td>Concentrates control by giving “friendly” shareholders more voting power than others</td>
<td>Difficult to implement because requires shareholder approval and only useful when voting power can be given to promanagement shareholders</td>
</tr>
<tr>
<td>Reincorporation</td>
<td>Takes advantage of most favorable state antitakeover statutes</td>
<td>Requires shareholder approval; time consuming to implement unless subsidiary established before takeover solicitation</td>
</tr>
<tr>
<td>Golden Parachutes*</td>
<td>Emboldens target management to negotiate for a higher premium and raises the cost of a takeover to the hostile bidder</td>
<td>Negative public perception; makes termination of top management expensive; cost not tax deductible</td>
</tr>
</tbody>
</table>

*Generally not considered a shark repellent but included in this table because they are usually put in place before a bid is made for the firm.
the board is greatest, whenever the offer price for the target is substantially above the target firm’s current share price. Staggered boards can be effective in helping a target to ward off a hostile takeover attempt.\footnote{Bebchuk, Coates, and Subramanian (2002, 2003).}

Some firms have common stock carrying \textit{cumulative voting rights} to maximize minority representation. Cumulative voting in the election of directors means each shareholder is entitled to as many votes as shall equal the number of shares the shareholder owns, multiplied by the number of directors to be elected. Furthermore, the shareholder may cast all of these votes for a single candidate or for any two or more candidates.

Again using the example of a 12-member board, a shareholder who has 100 shares of stock has 300 votes for three open seats for Class 1 directors. The shareholder may cumulate votes and cast them for a specific candidate. A dissident stockholder may choose this approach to obtain a single seat on the board to gain access to useful information that is not otherwise readily available. \textit{For cause provisions} specify the conditions for removing a member of the board of directors, narrowing the range of permissible reasons and limiting the flexibility of dissident shareholders in contesting board seats.

\textbf{Limiting Shareholder Actions}

The board can also reinforce its control by restricting the ability of shareholders to gain control of the firm by bypassing the board altogether. Limits can be set on shareholders’ ability to call special meetings, engage in consent solicitations, and use super-majority rules (explained later). Firms frequently rely on the conditions under which directors can be removed (i.e., the “for cause” provision discussed earlier) and a limitation on the number of board seats as defined in the firm’s bylaws or charter.

In some states, shareholders may take action—without a special shareholders’ meeting—to add to the number of seats on the board, remove specific board members, or elect new members. These states allow dissident shareholders to obtain shareholder support for their proposals simply by obtaining the written consent of shareholders under what is known as \textit{consent solicitation}, a process that still must abide by the disclosure requirements applicable to proxy contests (see Chapter 3). The process circumvents delays inherent in setting up a meeting to conduct a stockholder vote.

There is an important difference between a consent solicitation and a proxy contest. Whereas the winning vote in a proxy fight is determined as
a percentage of the number of votes actually cast (unless majority voting rules are in place, which require the counting of votes withheld), the winning vote in a consent solicitation is determined as a percentage of the number of shares outstanding. A dissident shareholder may, therefore, find it easier to win by initiating a proxy contest because many shareholders simply do not vote.

Companies have attempted to limit shareholders’ ability to use this procedure by amending charters or bylaws. Bylaw amendments may not require shareholder approval. However, the courts frequently have frowned upon actions that restrict shareholder rights without shareholder approval.

Corporate bylaws may include **advance notice provisions** that require shareholder proposals and board nominations be announced well in advance, sometimes as long as two months, of an actual vote. This buys time for the target’s management. **Super-majority rules** require a higher level of approval than is standard to amend the charter or for certain types of transactions, such as a merger or acquisition. Such rules are triggered when an “interested party” acquires a specific percentage of the ownership shares (e.g., 5 to 10 percent). Super-majority rules may require that as much as 80 percent of the shareholders must approve a proposed merger or a simple majority of all shareholders except the “interested party.” Super-majority rules often include **escape clauses** that allow the board to waive the requirement. For example, super-majority rules may not apply to mergers approved by the board.

**Other Pre-offer Defenses**

In addition to poison pills, there are some other pre-offer defenses, including antigreenmail, fair price provisions, supervoting stock, reincorporation, and golden parachutes.

**Antigreenmail Provisions**

During the 1980s, many raiders profited by taking an equity position in a target firm, threatening takeover, and subsequently selling their ownership position back to the target firm at a premium over what they paid for the target’s shares. The practice was dubbed **greenmail**—a neologism derived from **blackmail** and **greenback**. In response, many corporations adopted charter amendments called **antigreenmail provisions** that restrict the firm’s ability to repurchase shares at a premium. By removing the incentive for greenmail, companies believed they were making themselves less attractive as potential takeover targets.
Fair Price Provisions
Requirements that any acquirer pay minority shareholders at least a fair market price for their stock are called *fair price provisions*. The fair market price may be expressed as some historical multiple of the company’s earnings or as a specific price equal to the maximum price paid when the buyer acquired shares in the company. Fair price provisions are most effective when the target firm is subject to a two-tiered tender offer. The fair price provision forces the bidder to pay target shareholders, who tender their stock in the second tier, the same terms offered to those tendering their stock in the first tier. Most fair price provisions do not apply if the proposed takeover is approved by the target firm’s board of directors or if the bidder obtains a specified super-majority level of approval from the target’s shareholders.

Supervoting Stock
A firm may create more than one class of stock for many reasons, including separating the performance of individual operating subsidiaries, compensating subsidiary operating management, maintaining control with the founders, and preventing hostile takeovers. As a takeover defense, a firm may undertake a *dual class recapitalization* with the objective of concentrating stock with the greatest voting rights in the hands of those who are most likely to support management. One class of stock may have 10 to 100 times the voting rights of another class of stock. Such stock is called *supervoting stock*.

Supervoting stock is issued to all shareholders along with the right to exchange it for ordinary stock. Most shareholders are likely to exchange it for ordinary stock because the stock with the multiple voting rights usually has a limited resale market and pays a lower dividend than other types of voting stock the corporation issues. Typically, management retains the special stock, which effectively increases the voting control of the corporation in the hands of management. For example, Ford’s dual class or supervoting shares enable the Ford family to control 40 percent of the voting power while owning only 4 percent of the total equity of the company.

Under the voting rights policies of the SEC and major public exchanges, U.S. firms are allowed to list dual class shares. Once such shares are listed, however, firms cannot reduce the voting rights of existing shares or issue a new class of superior voting shares. Several hundred U.S. companies issue dual class shares, including the New York Times, Dow Jones,
the Washington Post, Coors, Tyson Foods, Adelphia, Comcast, Viacom, and Google. Still, such shares are far more common in other countries.\(^5\)

**Reincorporation**

In some instances, a potential target firm may change the state within which it is incorporated to one where the laws are more favorable for implementing takeover defenses. This is done by creating a subsidiary in the new state, into which the parent is merged at a later date.

Several factors need to be considered in selecting a state for such *reincorporation*, including how the state’s courts have ruled in lawsuits alleging breach of corporate director fiduciary responsibility in takeover situations, as well as the state’s laws pertaining to poison pills, staggered boards, and hostile tender offers. Reincorporation requires shareholder approval.

**Golden Parachutes**

An employee severance arrangement that is triggered whenever a change in control takes place is called a *golden parachute*. A change in control usually is defined as any time an investor accumulates more than a fixed percentage of the corporation’s voting stock. A golden parachute typically covers only a few dozen employees, who are terminated following the change in control and to whom the company is obligated to make a lump-sum payment. They are designed to raise the bidder’s cost of the acquisition by creating a cost for retaining management, rather than to gain time for the target board. Such severance packages may serve the interests of shareholders by making senior management more willing to accept an acquisition.

The Tax Reform Act of 1986 imposed stiff penalties on these types of plans if they create what is deemed an excessive payment—those that exceed three times the employee’s average pay over the previous five years—and treats them as income and hence not tax deductible by the paying corporation. The employee receiving the parachute payment must pay a 20 percent surcharge in addition to the normal tax due on the parachute payment.

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\(^5\) Research by Gompers, Ishii, and Metrick (2010) suggests that firms with dual class shares often underperform in the overall stock market. This may result from efforts to entrench controlling shareholders by erecting excessive takeover defenses and policies that are not in the best interests of noncontrolling shareholders, such as excessive compensation for key managers and board members. Moreover, such firms often have excessive leverage due to an unwillingness to raise additional funds by selling shares that could dilute the controlling shareholders.
POST-OFFER DEFENSES

After an unwanted suitor has approached a firm, various additional defenses can be introduced. They include greenmail to dissuade the bidder from continuing the pursuit; defenses designed to make the target less attractive, such as restructuring and recapitalization strategies; and efforts to place an increasing share of the company’s ownership in friendly hands by establishing employee stock ownership plans (ESOPs) or seeking white knights. Exhibit 4-4 summarizes the primary advantages and disadvantages of these post-offer defenses.

Greenmail

Greenmail (introduced earlier) is the practice of paying a potential acquirer to leave you alone. It consists of a payment to buy back shares at a premium price in exchange for the acquirer’s agreement not to commence a hostile takeover. In exchange for the payment, the potential acquirer is required to sign a standstill agreement, which typically specifies the amount of stock, if any, the investor can own, the circumstances under which the raider can sell stock currently owned, and the term of the agreement.

Courts view greenmail as discriminatory because not all shareholders are offered the opportunity to sell their stock back to the target firm at an above-market price. Nevertheless, courts in some states (e.g., Delaware) have found it to be an appropriate response if done for valid business reasons. Courts in other states (e.g., California) have favored shareholder lawsuits contending that greenmail breaches fiduciary responsibility.\(^6\)

White Knights

A target company seeking to avoid being taken over by a specific bidder may try to be acquired by a white knight—another firm viewed as a more appropriate suitor. To complete such a transaction, the white knight must be willing to acquire the target on terms more favorable than those of other bidders. This does not necessarily mean at a higher price; the more favorable terms may be the willingness of the white knight to allow the target firm’s management to remain in place to continue pursuing the firm’s current strategy.

Fearing that a bidding war might ensue, the white knight often demands some protection in the form of a lockup. This may involve giving the white knight options to buy stock in the target that has not yet

### EXHIBIT 4-4 Advantages and Disadvantages of Post-offer Takeover Defenses

<table>
<thead>
<tr>
<th>Type of Defense</th>
<th>Advantages for Target Firm</th>
<th>Disadvantages for Target Firm</th>
</tr>
</thead>
<tbody>
<tr>
<td>Greenmail</td>
<td>Encourages raider to go away (usually accompanied by a standstill agreement).</td>
<td>Reduces risk to raider of losing money on a takeover attempt; unfairly discriminates against nonparticipating shareholders; often generates litigation; and triggers unfavorable tax consequences and negative public image.</td>
</tr>
<tr>
<td>Standstill</td>
<td>Prevents raider from returning for a specific time period.</td>
<td>Increases amount of greenmail paid to get raider to sign standstill; provides only temporary reprieve.</td>
</tr>
<tr>
<td>Agreement</td>
<td></td>
<td></td>
</tr>
<tr>
<td>White Knights</td>
<td>May be a preferable to the hostile bidder.</td>
<td>Involves loss of target’s independence.</td>
</tr>
<tr>
<td>ESOPs</td>
<td>Alternative to white knight and highly effective if used in conjunction with certain states’ antitakeover laws.</td>
<td>Employee support not guaranteed. ESOP cannot overpay for stock because transaction could be disallowed by federal law.</td>
</tr>
<tr>
<td>Recapitalizations</td>
<td>Makes target less attractive to bidder and may increase target shareholder value if incumbent management motivated to improve performance.</td>
<td>Increased leverage reduces target’s borrowing capacity.</td>
</tr>
<tr>
<td>Share Buyback</td>
<td>Reduces number of target shares available for purchase by bidder, arbs, and others who may sell to bidder.</td>
<td>Securities laws limit ability to self-tender without SEC filing once hostile tender under way. A reduction in the shares outstanding may facilitate bidder’s gaining control.</td>
</tr>
<tr>
<td>Plans</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Corporate</td>
<td>Going private may be an attractive alternative to bidder’s offer for target shareholders and for incumbent management.</td>
<td>Going private, sale of attractive assets, making defensive acquisitions, or liquidation may reduce target’s shareholder value versus bidder’s offer.</td>
</tr>
<tr>
<td>Restructuring</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Litigation</td>
<td>May buy time for target to build defenses and increases takeover cost to the bidder.</td>
<td>May have negative impact on target shareholder returns.</td>
</tr>
</tbody>
</table>
been issued at a fixed price or to acquire specific target assets at a fair price. Such lockups usually make the target less attractive to other bidders. If a bidding war does ensue, the white knight may exercise the stock options and sell the shares at a profit to the acquiring company. German drug and chemical firm Bayer AG’s white knight bid for Schering AG in 2006 (which was recommended by the Schering board) was designed to trump a hostile offer from a German rival, Merck KGaS—and succeeded in repelling Merck.

**Employee Stock Ownership Plans**

ESOPs are trusts that hold a firm’s stock as an investment for its employees’ retirement program. They can be established quickly, with the company either issuing shares directly to the ESOP or having an ESOP purchase shares on the open market. The stock held by an ESOP is likely to be voted in support of management in the event of a hostile takeover attempt.

**Leveraged Recapitalization**

A company may recapitalize by assuming substantial amounts of new debt, which is used either to buy back stock or finance a dividend payment to shareholders. The additional debt reduces the company’s borrowing capacity and leaves it in a highly leveraged position, which makes it a less attractive target to a bidder that may have wanted to use that capacity to help finance a takeover. Moreover, the payment of a dividend or a stock buyback may persuade shareholders to support the target’s management in a proxy contest or hostile tender offer.

Whether the recapitalization actually weakens the target firm over the long term depends on its impact on shareholder value. Shareholders will benefit from the receipt of a dividend or from capital gains resulting from a stock repurchase. Furthermore, the increased debt service requirements of the additional debt will shelter a substantial amount of the firm’s taxable income and may encourage management to be more conscientious about improving the firm’s performance. Thus, the combination of these factors may result in current shareholders benefiting more from this takeover defense than from a hostile takeover of the firm. The primary differences between a leveraged recapitalization and a leveraged buyout are that the firm remains a public company and that management does not take a significant equity stake in the firm.

Recapitalization may require shareholder approval, depending on the company’s charter and the laws of the state in which it is incorporated.
Common Takeover Defenses

Share Repurchase or Buyback Plans

Firms repurchase shares to reward shareholders, signal undervaluation, fund ESOPs, adjust capital structure, and defend against unwanted takeovers. These repurchases can be executed either through a tender offer or by direct purchases of shares in public markets.

When used as an antitakeover tactic, share repurchase or buyback plans aim to reduce the number of shares that could be purchased by the potential acquirer or by arbitrageurs who will sell to the highest bidder. This tactic reflects the belief that when a firm initiates a tender offer (i.e., a self-tender) for a portion of its own shares, the shareholders who offer their shares for sale are those most susceptible to a tender offer by a hostile bidder. This leaves the target firm’s shares concentrated in the hands of shareholders who are less likely to sell, thereby reducing float. So, for a hostile tender offer to succeed in purchasing the remaining shares, the premium offered would have to be higher. The resulting higher premium might discourage some prospective bidders. A share buyback may work well in combination with a self-tender by allowing the firm to buy shares (perhaps at a somewhat higher price) in addition to those tendered to the firm. There is considerable evidence that buyback strategies are an effective deterrent.

The repurchase tactic may, however, be subject to the “law of unintended consequences.” Reducing the number of shares on the open market makes it easier for the buyer to gain control because fewer shares have to be purchased to achieve 50.1 percent of the target’s voting shares. Moreover, self-tenders may actually attract potential bidders if they are seen as a harbinger of improving target company cash flows.

Federal securities law prohibits purchase by an issuer of its own shares during a hostile tender offer for its shares. An exception is made if the firm files a statement with the SEC disclosing the identity of the purchaser, stock exchanges that will be used for the purchase, the intent of the purchase, and the intended disposition of the shares.

Corporate Restructuring

Restructuring may involve taking the company private, selling attractive assets, undertaking a major acquisition, or even liquidating the company.

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7 According to Billett and Xue (2007), firms frequently increase their share repurchase activities when confronted with an imminent takeover threat.

8 Potential acquirers are less likely to pursue firms with substantial excess cash, which could be used to adopt highly aggressive share repurchase programs (Faley, 2004; Harford, 1999; Pinkowitz, 2002).
“Going private” typically involves the management team’s purchase of the bulk of a firm’s shares. This may create a win–win situation for shareholders, who receive a premium for their stock and management, which retains control. To avoid lawsuits, the company must pay a price that represents a substantial premium to the current market price.

Alternatively, the target may make itself less attractive by divesting assets the bidder wants. The cash proceeds of such sales could fund other defenses, such as share buybacks or payment of a special stockholder dividend. A target company also may undertake a so-called defensive acquisition to draw down any excess cash balances and to exhaust its current borrowing capacity. A firm may choose to liquidate the company, pay off outstanding obligations to creditors, and distribute the remaining proceeds to shareholders as a liquidating dividend. This tactic makes sense only if the liquidating dividend exceeds what the shareholders would have received from the bidder.

Litigation
Takeover litigation often includes antitrust concerns, alleged violations of federal securities laws, inadequate disclosure by the bidder as required by the Williams Act of 1968, and alleged fraudulent behavior. Targets often seek a court injunction to stop the takeover attempt, at least temporarily, until the court has decided the merits of the allegations. By preventing the potential acquirer from acquiring more stock, the target firm is buying time to erect additional takeover defenses.

In mid-2008, Anheuser-Busch filed a lawsuit in federal court in an effort to stop its suitor, InBev, from attempting to replace its board of directors. The suit alleged that InBev had made numerous “false and misleading statements” in touting its financing as fully committed, because the commitments that it had received from lenders were full of conditions allowing them to walk away. Ultimately Anheuser-Busch agreed to be acquired by InBev.

THE IMPACT OF TAKEOVER DEFENSES ON SHAREHOLDER AND BONDHOLDER VALUE

In Chapter 2, you learned about the dramatic increase since the 1960s in the abnormal returns—to more than 30 percent, on average—to target shareholders around the time of a hostile tender offer announcement. Meanwhile, abnormal returns to acquirer shareholders have deteriorated
from marginally positive to slightly negative. Abnormal returns to target shareholders in friendly takeovers have remained at about 20 percent. What has spurred this increase in target company shareholder returns when hostile bids are at work? It could be potential improvements in efficiency, tax savings, or market power. However, if any of these were the explanation, we would be right to expect abnormal returns for mergers to show a correspondingly large increase over time—which they have not. Consequently, the explanation must lie elsewhere.

It is probably more than coincidental that the increase in abnormal returns began with the introduction of the 1967 Wallace Act prenotification period, which provides a respite for target firms to erect takeover defenses and search for other potential bidders. Takeover defenses such as poison pills, although unlikely to prevent a takeover, can add significantly to the overall purchase price. The purchase price can be boosted even further by any auction that might take place, as the initial bidder loses precious time in trying to overcome the myriad of defenses the target may be employing. Thus, the increasing sophistication of takeover defenses since 1980 would seem to be a highly plausible explanation—at least intuitively—for the sustained increase in abnormal returns to target shareholders following the announcement of a hostile tender offer.

Experience Shows Mixed Results

Unfortunately, the intuitive argument that experience shows results is difficult to substantiate. Some empirical evidence seems to suggest that takeover defenses in general have virtually no statistically significant impact on shareholder returns.\(^9\) Other evidence points to poison pills having a positive impact.\(^{10}\) Studies that find a positive return seem to support the idea that incumbent management acts in the best interests of shareholders (the shareholder interests theory), whereas those studies that find a negative

\(^9\) DeAngelo and Rice (1983) and Linn and McConnell (1983) both found no statistically significant negative results. Karpoff and Walkling (1996) found that shareholder efforts to remove takeover defenses had no significant impact on shareholder returns, suggesting that such efforts were viewed by investors as largely inconsequential. Field and Karpoff (2002), in a study of 1,019 initial public offerings between 1988 and 1992, found that takeover defenses had no impact on the takeover premiums of those firms acquired after the IPO.

\(^{10}\) Comment and Schwert (1995) found that poison pills would have a positive impact on shareholder returns if their addition by the target were viewed by investors as a signal that a takeover was imminent, or that the firm’s management would use such a defense to improve the purchase price during negotiation. The existence of poison pills often requires the bidder to raise its bid or to change the composition of its bid to an all-cash offer to put the target’s board under pressure to dismantle its pill defenses. Timing also is important. For example, whenever a merger
return seem to support the notion that incumbent management acts in its own interests (the management entrenchment theory). Overall, despite multiple studies, the research is largely contradictory.\(^\text{11}\)

More recent research has shifted some of the conclusions that might be drawn.

**Takeover Defenses May Destroy Shareholder Value**

Despite the largely mixed results from earlier studies, more recent research suggests that takeover defenses may actually destroy shareholder value. For instance, the creation of a detailed “management entrenchment index” revealed that firms at which management’s interests are more aligned with those of the shareholders have larger abnormal returns than firms with a high entrenchment index.\(^\text{12}\) Another large study provides additional evidence of the destructive effect of takeover defenses, finding that managers at firms protected by takeover defenses are less subject to the disciplinary power of the market for corporate control and are more likely to engage in “empire building” acquisitions that destroy shareholder value.\(^\text{13}\)

When firms move immediately from staggered board elections to annual elections of directors, they experience a cumulative abnormal return of 1.82 percent, reflecting investor expectations that the firm is

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11 Comment and Schwert (1995) provide a comprehensive review of previous studies, including Jarrell and Poulsen (1987), Malatesta and Walkling (1988), Ryngaert (1988), Karpoff and Malatesta (1989), and Romano (1993). From these studies, the authors found that most takeover defenses, such as staggered boards, super-majority provisions, fairprice provisions, reincorporation, and dual capitalization resulted in a slightly negative decline in shareholder returns of about 0.5 percent.

12 Bebchuk et al. (2005) created a management entrenchment index in an effort to assess which of 24 provisions tracked by the Investor Responsibility Research Center (IRRC) had the greatest impact on shareholder value. The index, which is negatively correlated with firm value between 1990 and 2003, comprises staggered boards, limits to shareholder bylaw amendments, super-majority requirements for mergers, super-majority requirements for charter amendments, poison pills, and golden parachutes. No correlation between firm value and 18 other IRRC provisions during the sample period was found. The researchers noted that the mere existence of correlation does not necessarily mean that these takeover defenses cause a reduction in the value of the firm. The correlation could reflect the tendency of underperforming firms that are likely to be takeover targets to adopt takeover defenses. These results supported the findings of an earlier study by Bebchuk, Cohen, and Ferrell (2005), which used a shorter time period.

more likely to be subject to a takeover. Often, such firms come under considerable pressure from activist shareholders—and the presence of a greater proportion of independent directors means that these firms are often more willing to submit to the demands of those activists.\textsuperscript{14}

**Takeover Defenses May Benefit Initial Public Offerings**

Event studies (a research approach introduced in Chapter 2) examine only how takeover defenses affect shareholder wealth after the corporation has been formed, shareholders have purchased its stock, and after employees and managers have been hired. It may be the case, though, that takeover defenses create significant firm value at the very point the firm is formed. Consequently, to evaluate fully the impact of takeover defenses on firm value requires giving consideration both to the potentially beneficial effects before the event of a takeover attempt and the potentially destructive effects on firm value after the announcement.

Takeover defenses may add to firm value before a takeover attempt if they help the firm attract, retain, and motivate effective managers and employees. Furthermore, such defenses give the new firm time to implement its business plan fully and invest in upgrading the skills of employees.\textsuperscript{15} There is also evidence that investors may prefer the adoption of takeover defenses during the early stages of a firm’s development.\textsuperscript{16}

**Takeover Defenses May Benefit Bondholders**

Companies with limited takeover defenses are often vulnerable to hostile takeovers, which may hurt bondholders.\textsuperscript{17} Although the increased potential for takeover may benefit shareholder investors, existing bondholders stand to lose if the takeover results in a significant increase in leverage. This is typical of a leveraged buyout. Higher leverage can reduce the value of current outstanding debt by increasing the potential for future bankruptcy.

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The rapidity of events once a takeover is underway may make an effective defense impossible unless certain defenses are already in place.

\textsuperscript{14} Guo et al. (2008).
\textsuperscript{15} Stout (2002).
\textsuperscript{16} This is suggested by the finding of Coates (2001) that the percentage of IPO firms with staggered boards in their charters at the time of the initial public offering rose from 34 percent in the early 1990s to 82 percent in 1999.
\textsuperscript{17} Cremers et al. (2004).
A pre-offer strategy involves building defenses that are adequate to the task of slowing down a bidder to give the target company’s management and board time to assess the situation and to decide on an appropriate response to an offer. A company’s strategy should never be to try to build insurmountable defenses. Courts will disallow defenses that appear to be designed only to entrench the firm’s management.

The recent trend shows U.S. corporations largely dismantling their takeover defenses; that is the evidence from the five years ending in 2007. The trend began with large capitalization firms, where it then slowed, but it spread to smaller firms as well, where it accelerated. Estimates for 2008 suggest that the trend for larger companies has begun to grow again, while the trend for smaller companies remains unchanged.

A Case in Point: Verizon Acquires MCI
Many parties showed an interest in acquiring the global telecommunications company MCI. How it played out illustrates the dynamics of a real transaction, employing many of the takeover tactics you learned about in Chapter 3 and some of the defenses you’ve learned about in this chapter also put to use to achieve a higher purchase price.

In the end, there were two major players. One was Qwest, which saw the acquisition as a way to ease its huge $17.3 billion debt burden (more than twice its stock market value), because the debt would be supported by the combined company with a much larger revenue and asset base; plus, the deal would also give the firm access to new business customers and opportunities to cut costs. The other was Verizon Communications, created through the merger of Bell Atlantic and GTE in 2000 and now the largest telecommunications provider in the United States. Merging with MCI would make it more efficient for Verizon to provide a broader range of services, give the firm access to MCI’s business customer base, accelerate new product development using MCI’s fiber-optic network infrastructure, and create substantial cost savings. By mid-2004, MCI had

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18 According to sharkrepellent.net, 1,400 U.S. firms had poison pills in place at the end of 2007. This compares to 2,200 firms with poison pills at the end of 2002. The percentage of S&P 500 firms with poison pills in place fell below 30 percent, as compared to 60 percent in 2002. The decline in overall takeover defenses resulted primarily from the removal of poison pills and the switch to annually elected boards from a staggered board system.

19 FactSet Merger Metrics reported that, in response to depressed equity prices, hostile takeover activity surged upward, comprising as much as one-fifth of U.S. deals announced in 2008. In an effort to ward off takeovers, 53 U.S. firms adopted their first pills, 20 percent more than in 2007. Of these, one-fourth were “in-play” adoptions undertaken in response to an unwanted takeover attempt.
received several expressions of interest from both firms about potential strategic relationships.

In July of that year, Qwest and MCI entered into a confidentiality agreement and proceeded to perform a more detailed due diligence. As the MCI board evaluated its strategic options—including Qwest’s proposal for a share-for-share merger following a one-time cash dividend to MCI shareholders from MCI’s cash in excess of its required operating balances—Verizon’s chairman/CEO also inquired about a potential takeover. The MCI board directed management to advise Qwest that MCI was not prepared to move forward with a potential transaction. This set the stage for what would become Qwest’s laboriously long and ultimately unsuccessful pursuit of MCI—during which the firm would be rejected by MCI four times.

After assessing its strategic alternatives, including the option to remain a standalone company, MCI’s board concluded merging with Verizon best served MCI’s stockholders. Verizon’s bid of $26.00 per share represented a 41.5 percent premium over the closing price of MCI’s common stock on January 26, 2005, and included “price protection” in the form of a collar. Furthermore, the merger agreement would allow MCI to declare a special $5.60 dividend after the firm’s shareholders approved the deal. MCI’s board also considered the additional value its stockholders would realize from a merger that was expected to be a tax-free reorganization: only the cash portion of the purchase price would be taxable, with the payment of taxes on any gains from the receipt of Verizon stock deferred until MCI shareholders chose to sell their shares. The final factor in favor of Verizon was that a large number of MCI’s most important business customers had indicated their preference of Verizon over Qwest.

The sequence of events reveals a great deal about Verizon’s possible bidding strategy, beginning with the firm’s assumptions about how to approach its target. Certainly, Verizon’s interests would be best served through a friendly takeover of MCI, especially given the challenges of integrating these two complex businesses. The special dividend payable by the target firm to its shareholders (contingent on their approval of the deal), part of Verizon’s approach, encouraged shareholder approval.

At first, Verizon seems to have based its bidding strategy on the low end of the price range it was willing to offer MCI—evidenced by the modest 3 percent premium over the first Qwest bid. There was a lot of consolidation going on at the time in the telecommunications industry, and competitors were in a weak financial position, so Verizon may have seen no need at first to share more than a little of the potential synergy with MCI shareholders. A bidding war, given the circumstances, seemed unlikely; and Qwest appeared unable to finance a substantial all-cash offer due to its excessive debt burden, and its stock appeared to have little appreciation potential because of ongoing operating losses. Perhaps
stunned by the persistence with which Qwest pursued MCI, Verizon believed that its combination of cash and stock would ultimately be more attractive to MCI investors than Qwest’s primarily all-cash offer, due to the partial tax-free nature of the bid.

Throughout the bidding process, many hedge funds—which had acquired significant positions in MCI stock because of the company’s potential for merger—criticized MCI’s board publicly for accepting the initial Verizon bid. MCI’s largest shareholder, Mexican telecom magnate Carlos Slim Helu, was particularly public and vocal about the MCI board’s failure to get full value for the firm’s shares. Pressure from hedge funds and other dissident MCI shareholders may have triggered a shareholder lawsuit to void the February 14, 2005, merger agreement signed with Verizon.

Expecting a possible proxy fight, Verizon chose to negotiate with Slim and ultimately acquired his 13.7 percent stake in MCI that April. Still, Verizon’s total stake in MCI remained below the 15 percent ownership level that would trigger the MCI rights plan.

About 70 percent ($1.4 billion) of the cash portion of Verizon’s proposed purchase price was represented by the special MCI dividend mentioned previously. Verizon’s management argued that the deal would cost their shareholders only $7.05 billion (i.e., the $8.45 billion purchase price less the MCI special dividend). The promise of the special dividend persuaded MCI shareholders to approve the deal, but the $1.4 billion special dividend reduced MCI’s cash in excess of what was required to meet its normal operating cash requirements.

Qwest consistently attempted to outmaneuver Verizon by establishing a significant premium between its bid and Verizon’s, often as much as 25 percent. Qwest realized that its current level of debt would preclude it from significantly increasing the cash portion of the bid, so the company had to rely on the premium to attract enough investor interest, particularly among hedge funds, to pressure the MCI board to accept the higher bid. But Qwest was never able to convince enough investors that its stock would not simply lose value when more shares were issued to consummate the stock and cash transaction. Qwest could have initiated a tender or exchange offer directly to MCI shareholders proposing to purchase or exchange their shares without going through the merger process. The tender process requires lengthy regulatory approval. However, if Qwest initiated a tender offer, it could trigger MCI’s poison pill. Alternatively, a proxy contest might have been preferable because Qwest already had a bid on the table and the contest would enable Qwest to lobby MCI shareholders to vote against the Verizon bid. This strategy would have avoided triggering the poison pill.

Ultimately, Qwest was forced to capitulate simply because it did not have the financial wherewithal to increase the $9.9 billion bid. It could not borrow any more because of its excessive leverage. Additional stock would have contributed to earnings dilution and caused the firm’s share price to fall.
This case also illustrates some governance issues you read about in Chapter 3. For instance, it is unusual for a board to turn down a higher bid, especially when the competing bid is 17 percent higher. In accepting the Verizon bid, MCI stated that a number of its large business customers had expressed the preference for Verizon noted earlier, and even noted concerns from these customers that acquisition by Qwest posed a significant risk. The MCI board’s acceptance of the lower Verizon bid could serve as a test case of how well MCI directors were conducting their fiduciary responsibilities. The central issue is how far boards can go in rejecting a higher offer in favor of one they believe will provide longer-term stability for the firm’s stakeholders.

The bidding war over MCI between Verizon and Qwest shows how forces beyond the company can force management and boards to modify their decisions. It featured an almost daily exchange between the bidders and highlighted the powerful role of hedge funds and arbitrageurs, who owned a majority of MCI shares and pushed the company to extract two higher bids from Verizon.

Things to Think About:
1. Discuss how changing industry conditions have encouraged consolidation within the telecommunications industry.
2. What alternative strategies could Verizon, Qwest, and MCI have pursued? Was the decision to acquire MCI the best alternative for Verizon? Explain your answer.
3. Who are the winners and losers in the Verizon/MCI merger? Be specific.
4. What takeover tactics did Verizon employ or threaten to employ? What tactics did Qwest employ or threaten to employ? Be specific.
5. What specific takeover defenses did MCI employ? Be specific.

Answers can be found at: www.elsevierdirect.com/companion.jsp?ISBN=9780123749482
Key Players in Mergers and Acquisitions

You learned in previous chapters about the motives for mergers and acquisitions, the factors that affect M&A performance, and common takeover tactics and defenses. In this chapter you will learn in detail about the numerous players who make mergers and acquisitions happen. What are their roles? Their responsibilities?

PROVIDERS OF SPECIALIZED SERVICES

The first category of key players includes the firms and individuals that provide specialized services during mergers and acquisitions. They include investment banks, lawyers, accountants, proxy solicitors, and public relations personnel. Each group is discussed in the following sections.

Investment Banks

Amid the turmoil of the 2008 credit crisis, the traditional model of the mega-independent investment bank as a highly leveraged, largely unregulated, innovative securities underwriter and M&A advisor floundered. Lehman Brothers was liquidated, and Bear Stearns and Merrill Lynch were acquired by commercial banks JPMorgan Chase and Bank of America, respectively. In an effort to attract retail deposits and to borrow from the U.S. Federal Reserve System (the “Fed”), Goldman Sachs and Morgan Stanley converted to commercial bank holding companies subject to Fed regulation.

Although the era of the thriving independent investment banking behemoth may be over, the financial markets will continue to require investment banking services. Traditional investment banking activities will continue to be in demand. They include providing strategic and tactical advice and acquisition opportunities; screening potential buyers and sellers; making initial contact with a seller or buyer; and providing negotiation support, valuation, and deal-structuring guidance. Along with these traditional investment banking functions, the large “universal banks” (e.g., Bank of America/Merrill Lynch) will maintain substantial broker–dealer operations, serving
wholesale and retail clients in brokerage and advisory capacities to assist with the complexity and often huge financing requirements of the mega-transactions. Investment banks also often provide large databases of recent transactions, which are critical in valuing potential target companies.

Investment bankers derive significant income from writing so-called fairness opinion letters—written and signed third-party assertions that certify the appropriateness of the price of a proposed deal involving a tender offer, merger, asset sale, or leveraged buyout. Such letters discuss the price and terms of the deal in the context of comparable transactions. A typical fairness opinion provides a range of “fair” prices, with the presumption that the actual deal price should fall within that range. Although such opinions are intended to inform investors, they often are developed as legal protection for members of the boards of directors against possible shareholder challenges of their decisions.¹

The size of the transaction will likely determine the size of the investment bank that can be used as an advisor. The largest investment banks are unlikely to consider any transaction valued at less than $100 million. In selecting an investment bank as a transaction advisor, the average magnitude of the abnormal returns on the announcement dates for those deals for which they serve as an advisor is far more important than the investment bank’s size or market share.² In other words, results count. Smaller, more focused, boutique advisors may be able to generate substantially higher returns for their clients than the mega-investment banks because of proprietary industry knowledge and relationships.

The large investment banks are more likely to be able to assist in funding large transactions because of their current relationships with institutional lenders and broker distribution networks. In large transactions, a group of investment banks, also referred to as a syndicate, agrees to purchase a new issue of securities (e.g., debt, preferred, or common stock) from the acquiring company for sale to the investing public. The banks within the syndicate that are underwriting or purchasing the issue are often different from the banks selling the issue, a group that often comprises those firms with the best broker distribution networks. After registering with the Securities and

¹ There are some problems associated with fairness opinions. They include the potential conflicts of interest with investment banks that generate large fees. In many cases, the investment bank that brings the deal to a potential acquirer is the same one that writes the fairness opinion. Moreover, these letters are often out of date by the time shareholders vote on the deal, they do not address whether the firm could have gotten a better deal, and the overly broad range of values given in such letters reduces their relevance. Courts agree that, because the opinions are written for boards of directors, the investment bankers have no obligation to the shareholders (Henry, November 24, 2003).

² Bao and Edmans (2008).
Exchange Commission (SEC), such securities may be offered to the investing public as an *initial public offering* (IPO), at a price agreed on by the issuer and the investment banking group. IPOs may be precursors to M&As: a parent firm may issue a portion of the stock in a wholly owned subsidiary to determine its value in anticipation of selling the entire subsidiary or of enabling the subsidiary to use the publicly traded shares to make acquisitions. Security issues may avoid the public markets and be privately placed with institutional investors, such as pension funds and insurance companies.\(^3\)

Investment banks charge an advisory fee that generally varies with the size of the transaction. Often contingent on completion of the deal, the fee may run about 1 to 2 percent of the value of the transaction; in some cases, the fee may exceed this amount if the advisors achieve certain incentive goals. Fairness opinion fees often amount to about one-fourth of the total advisory fee paid on a transaction,\(^4\) and typically are paid regardless of whether the deal is consummated.

**Lawyers**

Lawyers play a pervasive role in most M&A transactions.\(^5\) They are intimately involved in structuring the deal, evaluating risk, negotiating many of the tax and financial terms and conditions (based on input received from accountants; see following discussion), arranging financing, and coordinating the timing and sequence of events to complete the transaction. Specific tasks include drafting and reviewing the agreement of purchase and sale and other transaction-related documentation, providing opinion of counsel letters to the lender, and defining due diligence activities.

The legal framework surrounding a typical large transaction has become so complex that no one individual can have sufficient expertise to address all the issues. For these complicated transactions, legal teams can consist of more than a dozen attorneys, each bringing specialized expertise in a given aspect of the law such as M&As, corporate, tax, employee benefits, real estate, antitrust, securities, environmental, and intellectual property. In a hostile transaction, the team may grow to include litigation experts. In relatively small private transactions, lawyers play an active role in acquisition planning, including estate planning for individuals or for family

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\(^3\) Unlike public offerings, private placements do not have to be registered with the SEC if the securities are purchased for investment rather than for resale.

\(^4\) Sweeney (1999).

\(^5\) Leading M&A law firms, in terms of their share of the dollar value of transactions, include, at the time of this writing, Wachtell Lipton Rosen & Katz, Simpson Thacher & Bartlett, Skadden Arps Slate Meagher & Flom, Sullivan & Cromwell, and Davis Polk & Wardwell.
owned firms, tax planning, and working with management and other company advisors to help better position a client for a sale.

**Accountants**

Accountants\(^6\) provide advice on the financial structure, perform financial due diligence, and help create the most appropriate tax structure of a deal. A transaction can be structured in many ways, each structure having different tax implications for the parties involved. Because there is often a conflict in the tax advantages associated with the sales agreement from the buyer’s and seller’s perspective, the accountant must understand both points of view and find a mechanism whereby both parties benefit. Income tax, capital gains, sales tax, and sometimes gift and estate taxes are all at play in negotiating a merger or acquisition. The accountant’s input in this regard will affect how the transaction is structured and, ultimately, the after-tax amount each party will pay or receive in the deal.

In addition to tax considerations, accountants prepare financial statements and perform audits. Many agreements require that the books and records of the acquired entity be prepared in accordance with Generally Accepted Accounting Principles (GAAP), so accountants must be intimately familiar with those principles to assure that they have been applied appropriately. In performing due diligence, accountants also perform the role of auditors by reviewing the target’s financial statements and operations through a series of onsite visits and interviews with senior and middle-level managers.

The roles of the lawyer and accountant may blur depending on the size and complexity of the transaction. Sophisticated law firms with experience in mergers and acquisitions usually have the capacity to assist with the tax analysis. Furthermore, lawyers are often required to review financial statements for compliance with prevailing securities laws. It is helpful, especially when there can be an overlap of responsibilities, to define clearly which professional will be responsible for which tasks.

**Proxy Solicitors**

Proxy contests, discussed in detail in Chapter 3, are attempts to change management control or policies of a company by gaining the right to cast

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\(^6\) At this writing, the accounting industry is dominated by the group of firms called the “Big Four”: Ernst & Young, PricewaterhouseCoopers, KPMG, and Deloitte & Touche. Large regional firms (e.g., Grant Thornton and BDO Seidman) likely have some national and possibly some international clients, but they are largely tied to specific regional accounts. Local accounting firms operate in a number of cities and tend to focus on small businesses and individuals.
votes on behalf of other shareholders. In contests for the control of the board of directors of a target company, it can be difficult to compile mailing lists of stockholders’ addresses. The acquiring firm or dissident shareholders hire a proxy solicitor\(^7\) to obtain these addresses. The target’s management may also hire proxy solicitors to design strategies for educating shareholders and communicating why they should follow the board’s recommendations. Such strategies will include a detailed analysis of the shareholder base and vote projections designed to help determine the outcome of the campaign.

**Public Relations Firms**

Communicating a consistent position during a takeover attempt is vital. Inconsistent messages reduce the credibility of the parties involved. From the viewpoint of the acquiring company in a hostile takeover attempt, the message to the shareholders must be that its plans for the company will increase shareholder value more than the plans of incumbent management. Often, the target company’s management will hire a private investigator\(^8\) to develop detailed financial data on the acquiring company and do background checks on key personnel, later using that information in the public relations campaign in an effort to discredit publicly the management of the acquiring firm.

**INSTITUTIONAL INVESTORS AND LENDERS**

Institutional investors and lenders are organizations that pool large sums of money to invest in or lend to companies, and are an important source of M&A financing. Commercial banks, one type of institutional investor, have always played an important role in providing both short- and long-term financing, often backed by the assets of the target firm. Over time, however, other types of institutional investors have become increasingly important as sources of financing for corporate takeovers.

**Commercial Banks**

Traditionally, the model of a commercial bank is one that accepts checking, savings, and money market accounts and lends these funds to borrowers. After the Great Depression, the U.S. Congress required that commercial banks engage only in those traditional banking activities; they were not permitted to engage in investment banking activities.

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\(^7\) Georgeson & Company and D. E. King & Company are two major proxy solicitor firms.

\(^8\) There are many private investigators, but Kroll Associates is by far the largest such firm that frequently services target management.
The commercial bank makes a profit equal to the difference between what it pays on deposits and the cost of other borrowed funds and what it receives in making the loans. This model has evolved into one in which banks currently sell many of the loans they originate to other players in the financial system for whom buying, selling, and collecting on loans is their primary business. Commercial banks also derive an increasing share of their profits from fees charged for various types of services offered to depositors.

Changes made to the law in 1998 now permit commercial banks to engage in investment banking activities. However, the recent turmoil in the global credit markets may result in restrictions on such activities in the future.

**Insurance Companies**

An insurance company offers to mitigate risk for its customers in exchange for a fee or insurance premium. The main source of profit for insurance companies is the sale of insurance products (if they are able to price risk adequately), but they also make money by investing premium income that is not being paid out to customers to cover losses. Insurers invest premiums as soon as they are collected and continue to earn interest on them until claims are paid out.

**Pension Funds**

Employers establish pension funds to facilitate and organize the investment of retirement funds contributed by the employer and employees. These funds are asset pools intended to generate stable income growth over the long term to provide pensions for employees when they retire. Typically, pension funds are managed by a financial advisory service for the company and its employees, although some larger corporations operate their pension funds in-house.

Pension funds control relatively large amounts of capital and are the largest institutional investors in many countries. As large institutional investors, they are important shareholders of both publicly listed and private companies.

**Mutual Funds**

Mutual funds are pools of money professionally managed for the benefit of investors. They may focus on stocks, bonds, cash, or a combination of
these asset classes. A mutual fund’s portfolio is structured and maintained to match the investment objectives stated in its prospectus. Mutual funds can influence corporate policies by exercising the voting rights associated with their stockholdings.

Hedge and Private Equity Funds

Private equity funds and hedge funds usually are limited partnerships (for U.S. investors) or offshore investment corporations (for non–U.S. or tax-exempt investors) in which the general partner has made a substantial personal investment. This structure allows the general partner to achieve extensive control over the funds he or she manages, subject to relatively few legal restrictions. Other characteristics of partnerships that make them attractive include favorable tax benefits, a finite life, and investor liability limited to the amount of their investment. Institutional investors such as pension funds, endowments, insurance companies, and private banks, as well as individuals with high net worth, typically invest in these types of funds. When a partnership has reached its target size, the partnership closes to further investment, whether from new or existing investors.

At the end of 2007, there were approximately 9,000 hedge funds worldwide managing $1.9 trillion. This compares to some 3,000 private equity funds with about $500 billion under management. These numbers are likely to shrink dramatically by the end of 2010 due to the credit meltdown and global economic slowdown in 2008 and 2009.

Hedge funds and private equity funds are distinguished by their investment strategies, lockup periods (i.e., the length of time investors are required to commit funds), and the liquidity of their portfolios. Hedge fund investment strategies include trading a variety of financial instruments—debt, equity, options, futures, and foreign currencies—as well as higher-risk strategies such as corporate restructurings (e.g., LBOs) and credit derivatives (e.g., credit default swaps, which involve insuring the borrower against potential issuer default). Hedge fund investors typically find it easier to withdraw their money than those who invest in private equity funds, because they are subject to much shorter lockup periods. Because hedge funds need to maintain liquidity to satisfy investor withdrawals,

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9 For an exhaustive discussion of hedge fund investing, see Stefanini (2006).
10 Thomson Reuters Lipper/TASS Asset Flow report.
11 A survey by Hedge Fund Research indicates that hedge fund assets under management fell to about $1.4 trillion by the end of 2008, reflecting a combination of losses on invested assets and redemptions. This is about the same amount of assets under management at the end of 2006.
they focus on investments that can be converted to cash relatively easily, such as comparatively small investments in companies. Another way hedge funds maintain sufficient liquidity to satisfy investor withdrawals is to sell their investments after six to 18 months, with lockup periods for partners ranging from one to three years.

In contrast, private equity fund managers often make highly illiquid investments in nonpublicly listed securities of private companies. Investments often are made during the first two or three years of the fund, and these investments are maintained for five to seven years—during which time there are few new investments. Such funds invest in IPOs, LBOs, and corporate restructurings, and attempt to control risk by becoming more actively involved in managing the firm in which they have invested. Private equity fund partnerships usually last about 10 years, after which cash or shares in companies within the portfolio are distributed.

In the past, one could generalize by saying that hedge funds are traders, whereas private equity funds are more likely to be long-term investors. This distinction has blurred in recent years as hedge funds have taken more active roles in acquiring entire companies. The blurring of the differences between hedge and private equity funds reflects increased competition due to the growth in the number of funds and the huge infusion of capital that occurred between 2005 and mid–2007, making it more difficult for fund managers to generate superior returns.

Like mutual funds, hedge and private equity funds receive a management fee from participating investors, averaging about 2 percent of the assets under management. Hedge funds managers also receive “carried interest” of 20 percent of any profits realized from the sale of portfolio companies before any monies are distributed to investors. Furthermore, hedge funds and private equity investors typically receive fees from their portfolio companies for completing transactions, arranging financing, performing due diligence, and for monitoring business performance while the company is in the fund’s portfolio.

12 For example, the hedge fund Highfields Capital Management, which owned 7 percent of Circuit City, made a bid to buy the entire company in 2005. That same year, hedge fund manager Edward Lampert, after buying a large stake in Kmart, engineered an $11 billion takeover of Sears. The Blackstone Group (a private equity firm) and Lion Capital (a hedge fund) banded together to purchase the European beverage division of Cadbury Schweppes in early 2006. Blackstone also acted like a hedge fund that same year with its purchase of a 4.5 percent stake in Deutsche Telekom. According to Dealogic, hedge funds accounted for at least 50 leveraged buyouts in 2006.

13 Kaplan and Schoar (2005) found little evidence that private equity funds on average outperform the overall stock market when their fees are taken into account. In contrast, hedge funds have tended to outperform the overall market by 1 to 2 percentage points, even after fees are considered,
The 2008–2009 period proved to be transformational for both hedge funds and private equity investors, and 2008 was the worst year in terms of performance and redemptions since 1987—despite the promise by hedge funds to make money in bad years as well as good.\(^\text{14}\) It is clear that the tightening of credit conditions and the erosion of assets under management has caused a significant retrenchment of their investment activities. Hedge funds and private equity firms engaged in distressed debt exchanges to save some of the overleveraged companies in their investment portfolios from going into bankruptcy.\(^\text{15}\)

Hedge funds and private equity companies are likely to be more transparent and to lower management fees to attract new investors. Speculation that they will diminish in importance as financing sources, though, is highly premature. As markets return to their normal functioning, there will continue to be a need for investor groups to finance investments that may not be permissible under the charters of many pension and mutual funds. Alternative funding sources are critical for a vibrant growing economy to stimulate job growth and innovation.\(^\text{16}\) The U.S. government’s bank rescue plan in 2009 is recognition of the importance of such private capital.\(^\text{17}\)

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In any event, hedge funds are likely to be subject to more regulation in the future, such as a requirement that they register with the Securities and Exchange Commission (today, many hedge funds do this, but only voluntarily) and maintain larger capital reserves.

**Sovereign Wealth Funds**

Sovereign wealth funds (SWFs) are government-backed or -sponsored investment funds whose primary function is to invest accumulated reserves of foreign currencies and earn a profit. Countries that had accumulated huge quantities of U.S. dollars would, through such funds, reinvest the money in U.S. Treasury securities. They have been around for years, and collectively control almost $4 trillion in assets. Recently, these funds have begun to grow and are increasingly taking equity positions in foreign firms, making high-profile investments in public companies.

For the most part, the sovereign funds appear to be long-term, sophisticated investors. Having invested more than $40 billion in UBS, Morgan Stanley, Merrill Lynch, and Citigroup during 2008, the funds often are attracted by marquee brands. Moreover, they have thus far not demonstrated a desire to seek controlling interests. However, the disarray in the global capital markets in 2008 and 2009, and the resulting slide in the value of their investments, has caused many such funds to retrench by investing more in government securities than in individual firms.

**Venture Capital Firms**

Venture capitalists (VCs) are a significant source of funds for financing both startups and acquisitions and are sometimes willing to lend when the more traditional sources, such as banks, insurance companies, and pension funds, are unwilling because of perceived risk. Representing private equity capital, typically from institutional investors and individuals with high net worth, VC firms identify and screen opportunities, transact and close deals, monitor performance, and provide advice, adding value by providing managerial and technical expertise in addition to their capital contributions. VC firms typically provide capital to early-stage, high-potential, growth

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so-called toxic bank assets. The objective was to inject additional liquidity into the banks and enable them to augment their capital base. Hedge funds and private equity investors under the program were liable for losses they might incur in excess of 5 percent to 16 percent of their actual investment, depending on the type of asset-backed security they acquired.

18 The oldest SWF, Kuwait Investment Authority, began in 1953. Abu Dhabi Investment Authority (ADIA) and Temasek Holdings of Singapore have been around for more than 30 years.
companies with the expectation of generating a return through an eventual IPO or sale to a strategic investor. Investments generally are made in cash in exchange for shares in a company, and VCs usually demand a large equity position in the firm in exchange for paying a relatively low per-share price.19

**Angel Investors**

Angel investors are wealthy individuals who often band together in “investment clubs” or loose networks. Their objective is to generate deal flow, pool money, and share expertise. Some angel groups imitate professional investment funds, some affiliate with universities, whereas others engage in for-profit philanthropy. Angel investors often expect annual average returns of about 27 percent.20

**ACTIVIST INVESTORS**

Institutional activism (introduced in Chapter 3) has become an important factor in mergers and acquisitions. Institutions often play the role of activist investors to affect the policies of companies in which they invest and especially to discipline corporate management.

**Mutual Funds and Pension Funds**

Institutional ownership of public firms increased substantially over the past few decades.21 Although regulations restrict the ability of institutions to discipline corporate management, institutional investors with huge portfolios can be very effective in demanding governance changes.22

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19 General partners of venture capital firms receive a 2 to 3 percent fee and 15 to 25 percent of any capital gains from initial public offerings and mergers. The remaining 75 to 85 percent of capital gains, plus a return of principal, goes back to investors in the VC fund (Bygrave and Timmons, 1992). Only 2 to 4 percent of the firms contacting VC firms actually receive funding (Vachon, 1993).

20 However, the variability of such returns can be substantial. In their study of 1,137 “exits” between 1990 and 2007 through mergers, acquisitions, initial public offerings, reorganizations, and liquidations, Wiltbank and Boeker (2007) found that 7 percent of the sample had returns 10 times their original investments, and 39 percent did not make back their initial investment.

21 The percent of equity held by institutions was 49.1 percent in 2001, compared to 31 percent in 1970 (Federal Reserve Bulletin, December 2003, p. 33).

22 The Investment Company Act of 1940 restricts the ability of institutions to discipline corporate management. For example, mutual funds, to achieve diversification, are limited in the amount they can invest in any one firm’s outstanding stock. State regulations often restrict the share of a life insurance or property casualty company’s assets that can be invested in stock to as little as 2 percent.
In the 1980s, pension funds, mutual funds, and insurance firms were often passive investors, showing little interest in matters of corporate governance. Pension funds became more forceful in the 1990s, and there is further evidence that institutions are taking increasingly aggressive stands against management. For instance, TIAA-CREF—the New York–based investment company that manages pension plans for teachers, colleges, universities, and research institutions—believes it has a responsibility to push for better corporate governance and better stock performance. The Louisiana Teachers Retirement System brought legal pressure to bear on Siebel Systems Inc., resulting in a settlement in mid-2003 in which the software company agreed to make changes in its board and to disclose how it sets executive compensation, which had been criticized as excessive. In a case brought against some officers and directors of Sprint Corp. in 2003 by labor unions and pension funds, Sprint settled by agreeing to governance changes that require at least two-thirds of its board members to be independent.

Mutual funds are increasingly challenging management on such hot-button issues as antitakeover defenses, lavish severance benefits for CEOs, and employee stock option accounting. Voting against management, though, can be problematic because some mutual funds manage retirement plans and, increasingly, provide a host of outsourcing services—from payroll to health benefits—for their business clients. Mutual funds may own stock, on behalf of individual or institutional clients, in these same firms.23

Pressure from institutional activists may account for the general decline in the number of executives serving as both board chairman and CEO of companies.24 Sometimes, CEOs choose to negotiate with activists rather than face a showdown at an annual shareholders meeting. Activists are also finding that they may avoid the expense of a full-blown proxy fight simply by threatening to vote in certain ways on supporting a CEO or a management proposal. This many mean a “no” vote, although in some instances the only options are to vote in the affirmative or abstain. Abstaining is

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23 A study of the 24 largest mutual funds in the United States indicated that, in 2004, American Funds, T. Rowe Price, and Vanguard voted against management and for key shareholder proposals 70, 61, and 51 percent of the time, respectively—sharply higher than in 2003. However, industry leader Fidelity voted against management only 33 percent of the time (Davis and Kim, 2007; Farzad, 2006).

24 Brickley, Coles, and Jarrell (1997); Goyal and Park (2002). The number of executives serving in both positions of their companies declined from about 91 percent during the 1980s to 58 percent during the 1990s (Kini, Kracaw, and Mian, 2004).
a way to indicate dissatisfaction with a CEO or a firm’s policy without jeopardizing future underwriting or M&A business for the institution.\textsuperscript{25}

It should be noted, though, that institutional investor activism by mutual funds and pension funds has often failed to achieve significant benefits for shareholders.\textsuperscript{26}

**Hedge Funds and Private Equity Firms**

In recent years, hedge funds and private equity investors have increasingly played the role of activist investors, and with much greater success than other institutional investors. For instance, New York–based Knight Vinke Asset Management led a shareholder revolt in 2006 that prompted the $9.6 billion sale of the underperforming Dutch conglomerate VNU to a group of private equity investors. In 2007, Trian—a U.S. hedge fund—compelled soft drink and candy giant Cadbury Schweppes to split the firm in two after Trian took a 3 percent ownership position and threatened a proxy contest.

Activist hedge funds are successful (or partially so) about two-thirds of the time in their efforts to change a firm’s strategic, operational, or financial strategies. They seldom seek control (with ownership stakes averaging about 9 percent) and are most often nonconfrontational. Hedge fund activists tend to rely on cooperation from management or from other shareholders to promote their agendas. Research shows that there is an approximate 7 percent abnormal return around the date of the announcement that the hedge fund is initiating some form of action.\textsuperscript{27}

The relative success of hedge funds as activists can be attributed to the fact that their managers, who manage large pools of relatively unregulated capital, are highly motivated by the prospect of financial gain. Because hedge funds are not subject to the same regulations governing mutual funds and pension funds, they can hold highly concentrated positions in small numbers of firms. Moreover, hedge funds are not limited by the same conflicts of interests that afflict mutual funds and pension funds because

\textsuperscript{25} In an unprecedented expression of no confidence in early 2003, 43 percent of the votes cast were opposed to Michael Eisner continuing as chairman and CEO of Disney. Even though Eisner won a majority of the votes, the Disney board voted to strip him of his role as chairman. Later that year, Eisner announced that he would retire when his contract expired in 2006.

\textsuperscript{26} Black (1998); Gillan and Starks (2007); Karpoff (2001); and Romano (2001).

\textsuperscript{27} Brav et al. (2006). The authors argue that activist hedge funds occupy a middle ground between internal monitoring by large shareholders and external monitoring by corporate raiders. Clifford (2007) and Klein et al. (2009) also found that hedge fund activism can generate significant abnormal financial returns to shareholders.
they have few financial ties to the management of the firms whose shares they own and, unlike mutual funds, do not have other business such as clients services at risk.

Hedge funds as activist investors tend to have the greatest impact on financial returns to shareholders when they prod management to put a company up for sale. However, their impact rapidly dissipates if the sale of the company is unsuccessful. Firms once targeted by activists are more likely to be acquired.

A General Point about Activist Investors

It should be noted that even if shareholders vote overwhelmingly in favor of specific resolutions to amend a firm’s charter, boards need not implement these resolutions because most are only advisory. Managers need to be able to manage the business without significant outside interference from single-agenda dissident shareholders. It is analogous to the distinction between pure democracy, in which everyone has a vote in changing a law, and a representative democracy, in which only elected representatives vote on new legislation. Reflecting this distinction, shareholder proposals tend to be nonbinding because in many states, including Delaware, it is the firm’s board representing the shareholders, and not the shareholders themselves, that must initiate charter amendments.

M&A ARBITRAGEURS

When a bid is made for a target company, the target company’s stock price often trades at a small discount to the actual bid—reflecting the risk that the offer may not be accepted. Merger arbitrage refers to an investment strategy that attempts to profit from this spread. Arbitrageurs (arbs) buy the stock and make a profit on the difference between the bid price and the current stock price if the deal is consummated. Hedge fund managers often play the role of arbs.

Arbs may accumulate a substantial percentage of the stock held outside institutions so they can be in a position to influence the outcome of the takeover attempt. For example, if other offers for the target firm appear, arbs promote their positions directly to managers and institutional investors

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28 Greenwood and Schor (2009) found that under such circumstances, there is little change in the firm's share price or financial performance during the 18 months following the sale of the company, even if the firm follows the activist’s recommendations and buys back shares or adds new directors.
with phone calls and through leaks to the financial press. Their intent is to sell their shares to the highest bidder.

Acquirers involved in a hostile takeover attempt often encourage hedge funds to buy as much target stock as possible with the objective of gaining control of the target later by buying the stock from the hedge funds. In 2006, for instance, hedge funds acted as arbitrageurs and were the deciding factor in the battle over Swedish insurance company Skandia AB. Skandia opposed a takeover bid by Old Mutual PLC, but Old Mutual eventually gained control of Skandia because enough hedge funds purchased Skandia shares and sold their stock to Old Mutual.

Arbs monitor rumors and stock price movements to determine whether investors are accumulating a particular stock, seeking to identify a target before the potential acquirer is required by law to announce its intentions. Studies show that the price of a target company’s stock often starts to rise in advance of the announcement of a takeover attempt, the result of arb activity (and, possibly, insider trading). If one firm in an industry is acquired, it is commonplace for the share prices of other firms in the same industry to increase because those firms are viewed as potential takeover targets.

Arbs also provide market liquidity (i.e., the ease with which a security can be bought or sold without affecting its current market price) during transactions. In a cash-financed merger, the merger arbitrageur seeking to buy the target firm’s shares provides liquidity to the target’s shareholders that want to sell on the announcement day or shortly thereafter. Arbitrageurs may actually reduce liquidity for the acquirer’s stock in a stock-for-stock merger because they immediately “short” the acquirer shares (i.e., sell borrowed shares—paying interest to the share owner based on the value of the shares when borrowed—hoping to buy them back at a lower price). The downward pressure that widespread arb short selling puts on the acquirer’s share price at the time the transaction is announced makes it difficult for others to sell without incurring a loss from the premerger announcement price. Merger arbitrage short selling may account for about one-half of the downward pressure on acquirer share prices around the announcement of a stock-financed merger. Merger arbitrage also has the potential to be highly profitable.

29 Ascioglu, McInish, and Wood (2002).
31 A number of studies find that such arbitrage generates financial returns ranging from 4.5 percent to more than 100 percent in excess of what would be considered normal in a highly competitive market (Jindra and Walkling, 1999; Karolyi and Shannon, 1998; and Mitchell and Pulvino, 2001).
M&A price spreads indicate how arbs evaluate the likelihood that a proposed deal is actually going to happen. Exhibit 5-1 displays the arbitrage spread for selected announced mergers and acquisitions in 2008 and 2009 involving U.S. companies. The spreads represent the difference between the offer price and the share price immediately following the announcement as a percent of the current share price. A small positive spread indicates the belief that the deal is almost certain to take place, whereas a negative spread indicates that either the current bidder or another bidder is expected to raise the offer price.

**REGULATORS**

Regulations that affect merger and acquisition activity exist at all levels of government. Some are general: they affect all firms, and involve federal security, antitrust, environmental, racketeering, and employee benefits laws. Others are industry specific. Public utilities, insurance, banking, broadcasting, telecommunications, defense contracting, and transportation are examples of specific industries subject to substantial regulation. M&A activities in these industries often require government approvals to transfer government–granted licenses, permits, and franchises. State antitakeover statutes place limitations on how and when a hostile takeover may be implemented. Moreover, approval at both the state and federal levels may

<table>
<thead>
<tr>
<th>Acquirer</th>
<th>Target</th>
<th>Value of Deal ($Billions)</th>
<th>Price Per Share</th>
<th>Bid Price Spread (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pfizer Inc.</td>
<td>Wyeth</td>
<td>$66.8</td>
<td>$47.62</td>
<td>9.7</td>
</tr>
<tr>
<td>Roche Holdings</td>
<td>Genentech</td>
<td>$36.5</td>
<td>$86.50</td>
<td>4.22</td>
</tr>
<tr>
<td>Dow Chemical</td>
<td>Rohm and Haas</td>
<td>$15.2</td>
<td>$78.00</td>
<td>38.05</td>
</tr>
<tr>
<td>NRG Energy</td>
<td>Calpine</td>
<td>$10.9</td>
<td>$13.40</td>
<td>63.26</td>
</tr>
<tr>
<td>Exelon Corp.</td>
<td>NRG Energy</td>
<td>$6.2</td>
<td>$28.04</td>
<td>11.7</td>
</tr>
<tr>
<td>CenturyTel Inc.</td>
<td>Embarq Corp.</td>
<td>$5.7</td>
<td>$38.02</td>
<td>3.2</td>
</tr>
<tr>
<td>Consortium</td>
<td>Post Properties</td>
<td>$2.1</td>
<td>$47.00</td>
<td>291.01</td>
</tr>
<tr>
<td>CF Industries</td>
<td>Terra Industries</td>
<td>$1.9</td>
<td>$23.14</td>
<td>&lt;2.22&gt;</td>
</tr>
<tr>
<td>Abbott Labs</td>
<td>Advanced Medical</td>
<td>$1.4</td>
<td>$22.00</td>
<td>0.55</td>
</tr>
</tbody>
</table>

*Source: Reuters.*
be required for deals in certain industries. Cross-border transactions may be even more complicated because it may be necessary to obtain approval from regulatory authorities in all countries in which the acquirer and target companies do business.

**Exhibit 5-2** summarizes the various laws affecting M&A activity in the United States.

<table>
<thead>
<tr>
<th>EXHIBIT 5-2  Laws Affecting M&amp;A</th>
<th>Law</th>
<th>Intent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Federal Securities Laws</td>
<td>Securities Act (1933)</td>
<td>Prevents the public offering of securities without a registration statement; defines minimum data requirements and noncompliance penalties</td>
</tr>
<tr>
<td></td>
<td>Securities Exchange Act (1934)</td>
<td>Established the Securities and Exchange Commission (SEC) to regulate securities trading. Empowers Securities and Exchange Commission (SEC) to revoke registration of a security if issuer is in violation of any provision of the 1934 act</td>
</tr>
<tr>
<td></td>
<td>Section 13</td>
<td>Defines content and frequency of, as well as events triggering, SEC filings</td>
</tr>
<tr>
<td></td>
<td>Section 14</td>
<td>Defines disclosure requirements for proxy solicitation</td>
</tr>
<tr>
<td></td>
<td>Section 16(a)</td>
<td>Defines what insider trading is and who is an insider</td>
</tr>
<tr>
<td></td>
<td>Section 16(b)</td>
<td>Defines investor rights with respect to insider trading</td>
</tr>
<tr>
<td>Williams Act (1968)</td>
<td>Section 13</td>
<td>Regulates tender offers</td>
</tr>
<tr>
<td></td>
<td>Section 13</td>
<td>Defines disclosure requirements</td>
</tr>
<tr>
<td>Sarbanes-Oxley Act (2002)</td>
<td>Section 13</td>
<td>Initiates extensive reform of regulations governing financial disclosure, governance, auditing standards, analyst reports, and insider trading</td>
</tr>
<tr>
<td>Federal Antitrust Laws</td>
<td>Sherman Act (1890)</td>
<td>Made “restraint of trade” illegal. Establishes criminal penalties for behaviors that unreasonably limit competition</td>
</tr>
<tr>
<td></td>
<td>Section 1</td>
<td>Makes mergers creating monopolies or “unreasonable” market control illegal</td>
</tr>
<tr>
<td></td>
<td>Section 2</td>
<td>Applies to firms already dominant in their served markets to prevent them from “unfairly” restraining trade</td>
</tr>
</tbody>
</table>

(Continued)
### EXHIBIT 5-2 (Continued)

<table>
<thead>
<tr>
<th>Law</th>
<th>Intent</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Federal Antitrust Laws</strong></td>
<td></td>
</tr>
<tr>
<td>Clayton Act (1914)</td>
<td>Outlawed certain practices not prohibited by the Sherman Act such as price discrimination, exclusive contracts, and tie-in contracts and created civil penalties for illegally restraining trade; also established law governing mergers</td>
</tr>
<tr>
<td>Celler–Kefauver Act of 1950</td>
<td>Amended Clayton Act to cover asset as well as stock purchases</td>
</tr>
<tr>
<td>Federal Trade Commission Act (1914)</td>
<td>Established a federal antitrust enforcement agency; made it illegal to engage in deceptive business practices.</td>
</tr>
<tr>
<td>Hart–Scott–Rodino Antitrust Improvement Act (1976)</td>
<td>Requires waiting period before a transaction can be completed and sets regulatory data submission requirements</td>
</tr>
<tr>
<td>Title I</td>
<td>Defines what must be filed</td>
</tr>
<tr>
<td>Title II</td>
<td>Defines who must file and when</td>
</tr>
<tr>
<td>Title III</td>
<td>Enables state attorneys general to file triple damage suits on behalf of injured parties</td>
</tr>
<tr>
<td><strong>Other Legislation Affecting M&amp;A</strong></td>
<td></td>
</tr>
<tr>
<td>State Antitakeover Laws</td>
<td>Define conditions under which a change in corporate ownership can take place; may differ by state</td>
</tr>
<tr>
<td>State Antitrust Laws</td>
<td>Similar to federal antitrust laws; states may sue to block mergers, even if the mergers are not challenged by federal regulators</td>
</tr>
<tr>
<td>Exon-Florio Amendment to the Defense Protection Act of 1950</td>
<td>Establishes authority of the Committee on Foreign Investment in the United States (CFIUS) to review the impact of foreign direct investment (including M&amp;A) on national security</td>
</tr>
<tr>
<td>Industry-Specific Regulations</td>
<td>Banking, communications, railroads, defense, insurance, and public utilities</td>
</tr>
<tr>
<td>Environmental Laws (federal and state)</td>
<td>Define disclosure requirements</td>
</tr>
<tr>
<td>Labor and Benefit Laws (federal and state)</td>
<td>Define disclosure requirements</td>
</tr>
<tr>
<td>Applicable Foreign Laws</td>
<td>Cross-border transactions subject to jurisdictions of countries in which the bidder and target firms have operations</td>
</tr>
</tbody>
</table>
Securities and Exchange Commission

Whenever either the acquiring or the target company is publicly traded, the firms are subject to the substantial reporting requirements of the current federal securities laws administered by the Securities and Exchange Commission. Passed in the early 1930s, these laws were a direct result of the loss of confidence in the securities markets following the crash of the stock market in 1929.

The Securities Act of 1933 requires that all securities offered to the public must be registered with the SEC. Registration requires, but does not guarantee, that the facts represented in the registration statement and prospectuses are accurate. However, the law makes providing inaccurate or misleading statements in the sale of securities to the public punishable with a fine, imprisonment, or both. The registration process requires the description of the company’s properties and business, a description of the securities, information about management, and financial statements certified by public accountants. Section 8 of the law permits the registration statement to automatically become effective 20 days after it is filed with the SEC. However, the SEC may delay or stop the process by requesting additional information.

The Securities Exchange Act of 1934 extends disclosure requirements stipulated under the earlier act, covering new issues to include securities already trading on the national exchanges. In 1964, coverage was expanded to include securities traded on the over-the-counter (OTC) Market. Moreover, the act prohibits brokerage firms working with a company and others related to the securities transaction from engaging in fraudulent and unfair behavior, such as insider trading. The act also covers proxy solicitations (i.e., mailings to shareholders requesting their vote on a particular issue) by a company or shareholders, including when control of the board and management is involved, and requires the disclosure of the names and interests of all participants in the proxy contest. Proxy materials must be filed in advance of their distribution to ensure that they are in compliance with disclosure requirements. If the transaction involves the shareholder approval of either the acquirer or target firm, any materials distributed to shareholders must conform to the SEC’s rules for proxy materials.

Passed in 1968, the Williams Act\textsuperscript{32} is a set of amendments to the Securities Exchange Act of 1934. Its intent was to protect target firm shareholders from lightning-fast takeovers in which they would have neither

\textsuperscript{32} Sections 13(d) and 14(d) of the Williams Act are the most relevant to M&As.
sufficient information nor time to make an adequate assessment of the value of an acquirer’s offer. This protection was achieved by requiring more disclosure by the bidding company, establishing a minimum period during which a tender offer must remain open, and authorizing targets to sue bidding firms. The disclosure requirements of the Williams Act apply to anyone asking shareholders to accept or reject a takeover bid, including the target.

The prenotification procedures outlined in the Williams Act must be followed diligently. The act requirements apply to all types of tender offers, including those negotiated with the target firm (i.e., negotiated or friendly tender offers), those undertaken by a firm to repurchase its own stock (i.e., self-tender offers), and those that are unwanted by the target firm (i.e., hostile tender offers).

**Federal Trade Commission and Department of Justice**

Federal *antitrust laws* exist to prevent individual corporations from assuming a level of market power that makes them able to limit their output and raise prices without concern for any significant competitor reaction. The Department of Justice (DoJ) and the Federal Trade Commission (FTC) have primary responsibility for enforcing these laws. The FTC was established in the Federal Trade Commission Act of 1914 with the specific purpose of enforcing preceding antitrust laws such as the Sherman, Clayton, and Federal Trade Commission Acts.

Passed in 1890, the Sherman Antitrust Act remains the most important source of antitrust law today. The act defines broad conditions and remedies for such firms that are deemed to be in violation of current antitrust laws, and applies to all transactions and businesses involved in interstate commerce or, if the activities are local, all transactions and business “affecting” interstate commerce. It makes illegal all contracts, combinations, and conspiracies that “unreasonably” restrain trade. They include agreements to fix prices, rig bids, allocate customers among competitors, or monopolize any part of interstate commerce. Section I of the act prohibits new business combinations that result in monopolies or in a significant concentration of pricing power in a single firm. Section II applies to firms already dominant in their targeted markets.

The Clayton Antitrust Act was enacted in 1914 to strengthen the Sherman Antitrust Act. It outlaws certain practices not prohibited by the Sherman Act and helps the government stop a monopoly before it develops. Section 5 of the act makes price discrimination between customers
illegal, unless it can be justified by cost savings associated with bulk purchases. Tying of contracts—in which a firm refuses to sell certain important products to a customer unless the customer agrees to buy other products from the firm—also is prohibited. Section 7 prohibits mergers and acquisitions that may substantially lessen competition or tend to create a monopoly, and also makes it illegal for one company to purchase the stock of another company if their combination results in reduced competition within the industry. Interlocking directorates also are made illegal when the directors are on the boards of competing firms.

Unlike the Sherman Act, which contains criminal penalties, the Clayton Act is a civil statute. The Clayton Act allows private parties injured by the antitrust violation to sue in federal court for three times their actual damages. State attorneys general also may bring civil suits. If the plaintiff wins, costs must be borne by the party violating prevailing antitrust law, in addition to the criminal penalties imposed under the Sherman Act.

Acquirers soon learned how to circumvent the original 1914 statutes of the Clayton Act that applied to the purchase of stock. They simply would acquire the assets of a target firm, rather than the stock. So, the Celler–Kefauver Act of 1950 amended the Clayton Act to give the FTC the power to prohibit asset, as well as stock, purchases. The FTC also may block mergers if it believes that the combination will result in increased market concentration (i.e., fewer firms having increased market shares) as measured by the sales of the largest firms.

Although the 1967 Wallace Act requires prenotification under certain conditions for stock transactions, the 1976 Hart–Scott–Rodino Antitrust Improvements Act (HSR) was passed to require prenotification for asset acquisitions. Acquisitions involving companies of a certain size cannot be completed until certain information is supplied to the federal government and until a specified waiting period has elapsed. The premerger notification allows the FTC and the DoJ sufficient time to challenge acquisitions believed to be anticompetitive before they are completed. After the merger has taken place, breaking it up can be exceedingly difficult.

**Other Regulators**

In addition to the SEC, DoJ, and the FTC, various other agencies monitor activities in certain industries, such as commercial banking, railroads, defense, and cable TV. In each industry, the agency typically is responsible both for the approval of M&As and subsequent oversight. Mergers in these industries often take much longer to complete because of the additional
filing requirements. A diligent buyer also must ensure that the target is in compliance with the labyrinth of labor and benefit laws. These laws govern areas such as employment discrimination, immigration law, sexual harassment, age discrimination, drug testing, and wage and hour laws. Labor and benefit laws include the Family and Medical Leave Act, the Americans with Disabilities Act, and the Worker Adjustment and Retraining Notification Act (WARN). WARN governs notification before plant closings and requirements to retrain workers.

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The numerous participants in the M&A process play a variety of roles. Some provide specialized services. Others are investors of various sorts, sometimes representing individuals and other times representing huge pools of investors who have combined their capital. Some serve as funding sources specifically for M&A activity. Still others regulate the process.

**A Case in Point: Blackstone Outmaneuvers Vornado to Buy Equity Office Properties**

The sale and subsequent dismemberment of Equity Office Properties (EOP) illustrates the excesses of the commercial real estate boom in recent years. The story underscores the importance of timing and raises questions about how seemingly sophisticated institutional investors and lenders could be induced to make such poor investment decisions, while regulators appeared to ignore the “handwriting on the wall.” And, from a purely tactical perspective, the EOP case shows how the form of payment can be used as a key component of a takeover strategy.

EOP was established in 1976 by Sam Zell, a veteran property investor known for his ability to acquire distressed properties. Over three decades, he had amassed a portfolio of 573 properties. The Blackstone Group, one of the largest U.S. private equity buyout firms, first entered the commercial real estate market in 2005—part of a wave of capital flowing into that market from private equity investors. Vornado Realty Trust, a publicly traded real estate investment trust, had a long-standing reputation for savvy investing in the commercial real estate market. These were the players in our story.

After EOP’s management came under fire from investors for failing to sell properties fast enough and distribute the proceeds to shareholders, EOP signed a definitive agreement to be acquired by Blackstone for $48.50 per share in cash in November 2006, subject to approval by EOP’s shareholders. Vornado bid $52.00 per share—60 percent in cash and the remainder in Vornado
stock. The Vornado bid reflected a view that EOP’s breakup value exceeded Blackstone’s offer.

Blackstone countered with a bid of $54 per share, if EOP would raise the breakup fee from $200 million to $500 million. Ostensibly designed to compensate Blackstone for expenses incurred in its takeover attempt, the breakup fee also raised the cost of acquiring EOP by another bidder, which, as the new owner, would actually pay the fee. Within a week, Vornado responded with a bid valued at $56 per share. Still, EOP continued to favor Blackstone’s offer; the value was more certain because it could take three to four months before Vornado could get approval from its shareholders. What if Vornado’s stock declined in the interim or shareholders nixed the deal?

Reluctant to raise its offer price again, Vornado agreed to increase the cash portion of the purchase price and pay shareholders the cash more quickly than in its initial offer. However, Vornado did not offer to pay EOP shareholders a fee if Vornado’s shareholders did not approve the deal.

The next day, Blackstone increased its bid to $55.25 and eventually—at Zell’s behest—to $55.50, in exchange for another increase in the breakup fee, this time to $720 million. Vornado’s failure to counter gave Blackstone the win. On that news, Vornado’s stock jumped by 5.8 percent, and EOP’s fell by 1 percent to just below Blackstone’s final offer price. On February 8, 2007, Blackstone Group closed the purchase of EOP for $39 billion, consisting of about $23 billion in cash and $16 billion in assumed debt.

Blackstone’s strategy had been to sign contracts to presell selected EOP properties contingent on its closing of the deal with Sam Zell. This resulted in buyers purchasing buildings at what, in retrospect, were highly inflated prices. Fueled by historically low interest rates permitted by the U.S. Federal Reserve System, lenders were willing to finance the deals, lending up to 90 percent or more of the purchase price, because they were betting that rents, and therefore values, would continue to climb. Investment banks, including Morgan Stanley, Wachovia, Goldman Sachs, Bear Stearns, and Lehman Brothers collected fees for packaging the deals and selling the loans as securities to eager investors.

In fact, rental rates in most major urban markets collapsed in 2008 and 2009 as vacancy rates soared. With credit extremely tight, the ability to refinance these properties proved almost impossible. Building owners began to default on loans as they came due. What had begun in late 2007 as a recession centered largely in the residential housing market soon spread to other areas, including the commercial and office building markets. Both Sam Zell and the Blackstone Group were huge winners, although the value of the 105 properties Blackstone retained has fallen substantially.

Once again, timing proves to be the deciding factor in determining winners and losers in these types of M&A transactions.
Things to Think About:

1. Despite having a signed purchase agreement with Blackstone, Vornado bid $52 per share (60 percent cash and remainder in Vornado stock) and eventually $56 per share. What was the motivation for the Vornado bid and its cash and stock composition?

2. What was EOP’s response to the higher Vornado bids and why?

3. Describe Blackstone’s negotiating strategy with EOP to counter Vornado bids.

4. What could Vornado have done to assuage EOP’s concerns about the value of its stock?

5. Why did Blackstone have a huge incentive to close the deal?

Answers can be found at: www.elsevierdirect.com/companion.jsp?ISBN=9780123749482
Developing the Business Plan as the Initial Phase of the Merger and Acquisition Process

A poorly designed or inappropriate business strategy is among the reasons most frequently given when mergers and acquisitions fail to satisfy expectations. Too often, the overarching role planning should take in conceptualizing and implementing business combinations is ignored.

Many companies view mergers and acquisitions as a business growth strategy in and of themselves. Here, in accord with the view of successful acquirers, 1 M&As are considered a means of implementing a business strategy. Although firms may accelerate overall growth in the short run through acquisition, the higher growth rate often is not sustainable without a business plan—which also serves as a roadmap for identifying additional acquisitions to fuel future growth. Moreover, the business plan facilitates the integration of the acquired firms and the realization of synergy.

A sound business plan should be viewed as a necessary, but not sufficient, condition for achieving a company’s vision and objectives. Bank of America’s vision of becoming the number-one financial services provider in its domestic market drove the firm’s business strategy, which focused on broadening its product offerings and expanding its geographic coverage in the United States. This strategy was implemented by making opportunistic acquisitions, including troubled residential mortgage lender Countrywide in 2007 and financially ailing brokerage and investment bank Merrill Lynch in 2008. Bank of America’s failure to perform proper due diligence in making these acquisitions, however, may ultimately mean that they fail to meet expectations. Already, they have severely eroded Bank of America’s market value. Even the best-laid plans cannot save an acquirer from a poor execution of its business strategy.

To understand the role of planning in the M&A process, you need to understand the purpose of the acquiring firm’s mission and strategy. Here, you will be introduced to a planning-based approach to mergers and

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1 Palter and Srinivasan (2006).
acquisitions, comprising an integrated process of 10 interrelated phases. This chapter focuses on the initial phase—building the business plan—and on tools commonly used to evaluate, display, and communicate information to key constituencies both inside (e.g., board of directors and management) and outside (e.g., lenders and stockholders) the corporation. Subsequent chapters detail the remaining phases of the M&A process.

The planning concepts described here are largely prescriptive in nature: they recommend certain strategies based on the results generated by applying specific tools (e.g., experience curves) and answering checklists of relevant questions. Although these tools introduce some degree of rigor to strategic planning, their application should not be viewed as a completion of the planning process. Business plans must be updated frequently to account for changes in the firm’s operating environment and its competitive position within that environment. Indeed, business planning is not an event, but an evolving process.

**A PLANNING-BASED APPROACH TO MERGERS AND ACQUISITIONS**

The acquisition process envisioned here can be separated into two stages. The *planning* stage comprises developing business and acquisition plans. The *implementation* stage includes searching, screening, contacting the target, negotiating, integration planning, closing, integrating, and evaluating the acquisition.

**Key Business Planning Concepts**

A planning-based acquisition process comprises both a business plan and a merger/acquisition plan, which drive all subsequent phases of the acquisition process. The *business plan* articulates a mission or vision for the firm and a *business strategy* for realizing that mission for all of the firm’s stakeholders. *Stakeholders* are constituent groups such as customers, shareholders, employees, suppliers, lenders, regulators, and communities. The business strategy is oriented to the long term and usually cuts across organizational lines to affect many different functional areas. Typically, it is broadly defined and provides relatively little detail.

With respect to business strategy, it can be important to distinguish between the corporate level and the business level. *Corporate-level strategies* are set by the management of a diversified or multiproduct firm and generally cross business unit organizational lines. They entail decisions about

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2 For a more detailed discussion of business planning, see Deusen et al. (2007); Hunger and Wheeler (2007); and Thompson (2007).
financing the growth of certain businesses, operating others to generate cash, divesting some units, or pursuing diversification. Business-level strategies are set by the management of a specific operating unit within the corporate organizational structure and may involve that unit attempting to achieve a low-cost position in the markets it serves, differentiating its product offering, or narrowing its operational focus to a specific market niche.

The implementation strategy refers to the way in which the firm chooses to execute the business strategy. It is usually far more detailed than the business strategy. The merger/acquisition plan is a specific type of implementation strategy and describes in detail the motivation for the acquisition and how and when it will be achieved. Functional strategies describe in detail how each major function within the firm (e.g., manufacturing, marketing, and human resources) will support the business strategy. Contingency plans are actions that are taken as an alternative to the firm’s current business strategy. The selection of which alternative action to pursue may be contingent on certain events called trigger points occurring (e.g., failure to realize revenue targets or cost savings), at which point a firm faces a number of alternatives sometimes referred to as real options. These options include abandoning, delaying, or accelerating an investment strategy. Unlike the strategic options discussed later in this chapter, real options are decisions that can be made after a business strategy has been implemented.

THE ACQUISITION PROCESS

An acquisition process can be thought of as a series of largely independent events culminating in the transfer of ownership from the seller to the buyer. This process facilitates the communication and understanding required to complete the transaction. Thinking of M&As as a transaction-tested process, while not ensuring success, increases the likelihood of meeting or exceeding expectations.

Good Planning Expedites Sound Decision Making

Some individuals shudder at the thought of following a structured process because they believe it may delay responding to opportunities, both anticipated and unanticipated. Anticipated opportunities are those identified as a result of the business planning process: understanding the firm’s external operating environment, assessing internal resources, reviewing a range of reasonable options, and articulating a clear vision of the future of the business and a realistic strategy for achieving that vision. Unanticipated opportunities

3 Hill and Jones (2001).
may emerge as new information becomes available. Having a well-designed business plan does not delay pursuing opportunities; rather, it provides a way to evaluate the opportunities, rapidly and substantively. Decisions made in the context of a business plan are made with the confidence that comes from already having asked and answered the difficult questions.

**Mergers and Acquisitions Are a Process, Not an Event**

Exhibit 6–1 illustrates the 10 phases of the acquisition process described in this and subsequent chapters. These phases fall into two distinct sets of activities: pre- and postpurchase decision activities. They are summarized here:

*Phase 1:* Business Plan—Develop a strategic plan for the entire business.

*Phase 2:* Acquisition Plan—Develop an acquisition plan supporting the business plan.

*Phase 3:* Search—Actively search for acquisition candidates.

*Phase 4:* Screen—Screen and prioritize potential candidates.

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**EXHIBIT 6–1 The Acquisition Process Flow Diagram**

### Phases

1. Business Plan
2. Acquisition Plan
3. Search
4. Screen
5. First Contact
6. Negotiation (Purchase Decision)
7. Integration Plan
8. Closing
9. Integration
10. Evaluation

**Prepurchase Decision Activities**

- Refine Valuation
- Structure Deal
- Perform Due Diligence
- Develop Financing Plan
- Decision: Close or Walk Away

**Postpurchase Decision Activities**

- Integration Plan
- Evaluation
Phase 5: First Contact—Initiate contact with the target.
Phase 6: Negotiation—Refine valuation, structure a deal, perform due diligence, and develop a financing plan.
Phase 7: Integration Plan—Develop a plan for integrating the acquired business.
Phase 8: Closing—Obtain necessary approvals, resolve postclosing issues, and execute the closing.
Phase 9: Integration—Implement postclosing integration.
Phase 10: Evaluation—Conduct postclosing evaluation of the acquisition.

Negotiation, with its four largely concurrent and interrelated activities, is the crucial phase of the acquisition process. The decision to purchase or walk away is determined as a result of continuous iteration through the four activities comprising the negotiation phase. Assuming the transaction is ultimately completed, the actual price paid for the target is determined during the negotiation phase. The phases of the acquisition process are summarized in the following section.

BUILDING THE BUSINESS PLAN

A well-designed business plan results from eight key activities, summarized here. In practice, the process of developing a business plan can be facilitated by addressing a number of detailed questions corresponding to each of these activities.4

The first activity is the external analysis to determine where to compete—that is, which industry or market(s)—and how to compete—that is, how the firm can most effectively compete in its chosen market(s). This activity is followed by the internal analysis, or self-assessment, of the firm’s strengths and weaknesses relative to its competition. The combination of these two activities—the external and internal analyses—is often called SWOT analysis because it determines the strengths, weaknesses, opportunities, and threats of a business. When this exhaustive analysis is completed, management has a clearer understanding of emerging opportunities and threats to the firm and of the firm’s primary internal strengths and weaknesses. Information gleaned from the external and internal analyses drives the development of business, implementation, and functional strategies. Each level of strategy involves an increased level of detail.

4 Extensive checklists can be found in Porter (1985) and Stryker (1986). Answering these types of questions requires gathering substantial economic, industry, and market information.
The third activity is to define a mission statement that summarizes where and how the firm has chosen to compete, based on the external analysis, as well as management’s basic operating beliefs and values. Fourth, objectives are set, and quantitative measures of financial and non-financial performance are developed. Having completed these steps, the firm is ready to select a business strategy that is most likely to achieve the objectives in an acceptable period, subject to constraints identified in the self-assessment. The business strategy defines, in general terms, how the business intends to compete (i.e., through cost leadership, differentiation, or increased focus).

Next, an implementation strategy is selected that articulates the best way to implement the business strategy from among a range of reasonable options. It may be that the firm opts to act on its own, partner with others, or acquire/merge with another firm. This activity is followed by development of a functional strategy that defines the roles, responsibilities, and resource requirements of each major functional area within the firm needed to support the business strategy. Functional strategies often entail setting objectives and performance milestones for each employee supporting the implementation strategy.

The final step is to establish strategic controls to monitor actual performance to plan, implement incentive systems, and take corrective actions as necessary. These controls are put in place to heighten the prospect that the firm’s vision, objectives, and strategies will be realized on schedule. They may involve establishing bonus plans and other incentive mechanisms to motivate all employees to achieve their individual objectives on or ahead of schedule. Systems are also put in place to track the firm’s actual performance to plan. Significant deviations from the implementation plan may require switching to contingency plans.

Let’s look at each of these steps in greater detail.

EXTERNAL ANALYSIS

The external analysis involves the development of an in-depth understanding of the business’s customers and their needs, underlying market dynamics or factors determining profitability, and emerging trends that affect customer needs and market dynamics. This analysis begins with answering two basic questions: where and how to compete. The primary output of the external analysis is the identification of important growth opportunities and competitive threats.
Determining Where to Compete

There is no more important activity in building a business plan than deciding where a firm should compete. It begins with identifying the firm’s current and potential customers and their primary needs, and is based on the process of market segmentation, which involves identifying customers with common characteristics and needs.

Whether made up of individual consumers or other firms, a collection of customers comprises a market. A collection of markets is said to comprise an industry—for example, the automotive industry, which comprises the new and used car markets as well as the aftermarket for replacement parts. Markets may be further subdivided by examining cars by makes and model years. The automotive market could also be defined regionally (e.g., New England, North America, Europe), or by country. Each subdivision, whether by product or geographic area, defines a new market within the automotive industry.

A three-step process is used to identify a target market. First, the firm establishes evaluation criteria to distinguish the attractiveness of multiple potential target markets. These criteria may include market size and growth rate, profitability, cyclicality, the price sensitivity of customers, amount of regulation, degree of unionization, and entry and exit barriers. The second step is to subdivide industries and the markets within these industries repeatedly and analyze the overall attractiveness of these markets in terms of the evaluation criteria. For each market, each criterion is given a numerical weight (some even at zero) reflecting the firm’s perception of its relative importance as applied to that market. Higher numbers imply greater perceived importance. The markets are then ranked from 1 to 5 according to the evaluation criteria, with 5 indicating that the firm finds a market to be highly favorable in terms of a specific criterion. In the third step, a weighted average score is calculated for each market, and the markets are ranked according to their respective scores.

Determining How to Compete

Determining how to compete requires a clear understanding of the factors critical for successfully competing in the targeted market. This outward-looking analysis applies to the primary factors governing the firm’s external environment. Understanding market dynamics and knowing the areas in which the firm must excel in comparison to the competition is crucial if the firm is to compete effectively in its chosen market.
Market profiling entails collecting sufficient data to assess and characterize accurately a firm’s competitive environment within its chosen markets. Using Michael Porter’s well-known “Five Forces” framework (also known as the Porter or Modified Porter framework), the market or industry environment can be described in terms of competitive dynamics such as the firm’s customers, suppliers, current competitors, potential competitors, and product or service substitutes. The three potential determinants of the intensity of competition in an industry include competition among existing firms, the threat of entry of new firms, and the threat of substitute products or services. Although the degree of competition determines whether there is potential to earn abnormal profits (i.e., those in excess of what would be expected for the degree of assumed risk), the actual profits or cash flow is influenced by the relative bargaining power of the industry’s customers and suppliers.

This framework may be modified to include other factors that determine actual industry profitability and cash flow, such as the severity of government regulation or the impact of global influences such as fluctuating exchange rates. Labor costs may also be included. Although they represent a relatively small percentage of total expenses in many areas of manufacturing, they frequently constitute the largest expense in the non-manufacturing sector. The analysis should also include factors such as the bargaining power of labor.

Exhibit 6–2 brings together these competitive dynamics. The data required to analyze industry competitive dynamics include types of products and services; market share (in terms of dollars and units); pricing metrics; selling and distribution channels and associated costs; type, location, and age of production facilities; product quality metrics; customer service metrics; compensation by major labor category; research and development (R&D) expenditures; supplier performance metrics; and financial performance (in terms of growth and profitability). These data must be collected on all significant competitors in the firm’s chosen markets.

**Determinants of the Intensity of Industry Competition**

The overall intensity of industry competition is a function of different factors in several categories. Industry growth rate, industry concentration, degree of differentiation and switching costs, scale and scope economies, excess capacity, and exit barriers all affect the intensity of competition.
Developing the Business Plan as the Initial Phase of the Merger and Acquisition Process

EXHIBIT 6-2  Defining Market/Industry Competitive Dynamics  
(Adapted from Palepu, Healy, and Bernard, 2004, p. 2-2)

Determinants of the Intensity of Industry Competition

<table>
<thead>
<tr>
<th>Determinants of Competition Among Existing Firms Affected By:</th>
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<tbody>
<tr>
<td>Industry Growth Rate</td>
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<tr>
<td>Industry Concentration</td>
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<tr>
<td>Switching Costs</td>
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<tr>
<td>Scale/Scope Economies</td>
</tr>
<tr>
<td>Excess Capacity</td>
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<tr>
<td>Exit Barriers</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Determinants of Potential for New Entrants Affected By:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Scale/Scope Economies</td>
</tr>
<tr>
<td>First Mover Advantage</td>
</tr>
<tr>
<td>Legal Barriers (e.g., Patents)</td>
</tr>
<tr>
<td>Limited Access to Distribution Channels</td>
</tr>
<tr>
<td>Product Differentiation</td>
</tr>
<tr>
<td>Current Competitor Retaliation</td>
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</tbody>
</table>

<table>
<thead>
<tr>
<th>Determinants of Potential for Substitute Products Affected By:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Relative Prices</td>
</tr>
<tr>
<td>Relative Performance</td>
</tr>
<tr>
<td>Relative Quality</td>
</tr>
<tr>
<td>Relative Service</td>
</tr>
<tr>
<td>Willingness of Customers to Switch</td>
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</tbody>
</table>

Determinants of Actual Profits and Cash Flow

<table>
<thead>
<tr>
<th>Determinants of Bargaining Power of Customers Affected By:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Buying Criteria</td>
</tr>
<tr>
<td>Price Sensitivity</td>
</tr>
<tr>
<td>Switching Costs</td>
</tr>
<tr>
<td>Number and Average size of Buyers</td>
</tr>
<tr>
<td>Availability of Substitutes</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Determinants of Bargaining Power of Suppliers (Incl. Material, Service, and Capital) Affected By:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Switching Costs</td>
</tr>
<tr>
<td>Differentiation</td>
</tr>
<tr>
<td>Number and Average size of Suppliers</td>
</tr>
<tr>
<td>Availability of Substitutes</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Determinants of Bargaining Power of Labor Force Affected By:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Degree of Unionization</td>
</tr>
<tr>
<td>Management/Labor Harmony</td>
</tr>
<tr>
<td>Availability of Critical Skills</td>
</tr>
</tbody>
</table>

Determinants of Degree of Government Regulation Affected By:

<table>
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<tr>
<th>Determinants of Global Exposure Affected By:</th>
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</thead>
<tbody>
<tr>
<td>Dependence on Foreign Sales</td>
</tr>
<tr>
<td>Extent of Foreign Operations</td>
</tr>
<tr>
<td>Exchange Rate</td>
</tr>
<tr>
<td>Volatility</td>
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<tr>
<td>Political Risk</td>
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</tbody>
</table>

among current industry competitors, the first category. If an industry is growing rapidly, existing firms have less need to compete for market share. If an industry is highly concentrated, firms can more easily coordinate their pricing activities; in contrast, this activity is more difficult in a highly fragmented industry in which price competition is likely to
be very intense. If the cost of switching from one supplier to another is minimal because of low perceived differentiation, customers are likely to switch based on relatively small differences in price. In industries in which production volume is important, companies may compete aggressively for market share to realize economies of scale. Moreover, firms in industries exhibiting substantial excess capacity often reduce prices to fill unused capacity. Finally, competition may be intensified in industries in which it is difficult for firms to exit due to high exit barriers, such as large unfunded pension liabilities and single-purpose assets.

The second category is the potential for new entrants. Current competitors within an industry characterized by low barriers to entry have limited pricing power. Attempts to raise prices resulting in abnormally large profits will attract new competitors, thereby adding to the industry’s productive capacity. In contrast, high entry barriers may give existing competitors significant pricing power. Barriers to new entrants include situations in which the large-scale operations of existing competitors give them a potential cost advantage due to economies of scale. New entrants may enter only if they are willing to invest in substantial additional new capacity. The “first-mover advantage”—that is, being an early competitor in an industry—may also create entry barriers because first-movers achieve widespread brand recognition, establish industry standards, and/or develop exclusive relationships with key suppliers and distributors. Finally, legal constraints, such as copyrights and patents, may inhibit the entry of new firms.

Examples of new entrants abound. Amazon.com sells the same books and CDs available at traditional brick-and-mortar stores, but online. Internet-based technologies are already an enormous threat to cable television, and new entrants AT&T and Verizon—both telephone giants—are using these technologies to offer consumers a variety of movies and TV shows that could be watched at any time. Meanwhile, program owners such as ESPN are working with consumer electronics manufacturers to develop a box that sits on top of a television and provides access to college football games not available on cable or satellite. Users of Apple Computer’s iPod can watch shows from Disney’s ABC unit.

These examples of new entrants also apply to the third category, which is the potential for substitute products and services. The selling price of one product compared to a close substitute—called the relative price—determines the threat of substitution, along with the performance of competing products, perceived quality, and the willingness of the customer to
switch. Potential substitutes include those that are substantially similar to existing products and those performing the same function—for example, an MP3 rather than a CD, a Kindle wireless reading device rather than a book, or even a paperless airline ticket. Other examples include e-mail and faxes as substitutes for letters.

**Determinants of Actual Profits and Cash Flow**

The bargaining power of customers, suppliers, and the labor force are important factors that affect profits and cash flow. Others include the degree of government regulation and global exposure. The relative bargaining power of buyers depends on their primary buying criteria (i.e., price, quality/reliability, service, convenience, or some combination), price sensitivity or elasticity, switching costs, and their number and size compared to the number and size of suppliers. For example, a customer whose primary criteria for making a purchase are product quality and reliability may be willing to pay a premium for a Toyota because it is perceived to have higher relative quality. Customers are more likely to be highly price sensitive in industries characterized by largely undifferentiated products and low switching costs. Finally, buyers are likely to have considerable bargaining power when there are relatively few large buyers relative to the number of suppliers.

The relative leverage of suppliers reflects the ease with which customers can switch suppliers, perceived differentiation, their number, and how critical they are to the customer. Switching costs are highest when customers must pay penalties to exit long-term supply contracts or when new suppliers would have to undergo an intensive learning process to meet the customers’ requirements. Moreover, reliance on a single or a small number of suppliers shifts pricing power from the buyer to the seller. Examples include Intel’s global dominance of the microchip market and Microsoft’s worldwide supremacy in the market for personal computer operating systems.

Work stoppages create opportunities for competitors to gain market share. Customers are forced to satisfy their product and service needs elsewhere. Although the loss of customers may be temporary, it may become permanent if the customers find that another firm’s product or service is superior. Frequent work stoppages also may have long-term impacts on productivity and production costs as a result of a less-motivated labor force and increased labor turnover. High turnover can contribute to escalating operating expenses as firms incur substantial search and retraining expenses to fill positions.
Governments may choose to regulate industries that are heavily concentrated, are natural monopolies (e.g., electric utilities), or provide a potential risk to the public. Regulatory compliance adds significantly to an industry’s operating costs. Regulations also create barriers to both entering and exiting an industry. The government may choose to regulate heavily concentrated industries to minimize anticompetitive practices, or those such as utilities in which the economics justify relatively few competitors. Companies wishing to enter the pharmaceutical industry must be able to produce and test new drugs that satisfy the U.S. Food and Drug Administration. Companies with large unfunded or underfunded pension liabilities may find exiting an industry impossible until they have met their pension obligations to the satisfaction of the U.S. Pension Benefit Guaranty Corporation.

Global exposure is the extent to which participation in an industry necessitates having a multinational presence. For example, the automotive industry is widely viewed as a global industry in which participation requires having assembly plants and distribution networks in major markets throughout the world. As the major auto assemblers move abroad, they need their parts suppliers to build nearby facilities to ensure “just-in-time” delivery. Global exposure introduces the firm to significant currency risk, as well as political risk that could result in the confiscation of the firm’s properties.

**INTERNAL ANALYSIS**

The primary output of *internal analysis* is to determine the firm’s strengths and weaknesses. What are they as compared to the competition? Can the firm’s critical strengths be easily duplicated and surpassed by the competition? Can they be used to gain advantage in the firm’s chosen market? Can competitors exploit the firm’s key weaknesses? These questions must be answered as objectively as possible for the information to be useful in formulating a viable strategy.

Ultimately, competing successfully means doing a better job than competitors of satisfying the needs of the firm’s targeted customers. A self-assessment identifies those strengths or competencies—so-called *success factors*—necessary to compete successfully in the firm’s chosen or targeted market. These factors may include high market share compared to the competition, product line breadth, cost-effective sales distribution channels, age and geographic location of production facilities, relative product
Developing the Business Plan as the Initial Phase of the Merger and Acquisition Process

quality, price competitiveness, R&D effectiveness, customer service effectiveness, corporate culture, and profitability.

Recall that the combination of the external and internal analyses just detailed can be done as a SWOT analysis; it determines the strengths, weaknesses, opportunities, and threats of a business. Exhibit 6-3 illustrates a hypothetical SWOT analysis, in this case for Amazon.com. It suggests that Amazon.com sees becoming an online department store as its greatest opportunity, while its greatest threat is the growing online presence of sophisticated competitors. The SWOT analysis then summarizes how Amazon.com might perceive its major strengths and weaknesses in the context of this opportunity and threat. This is the sort of information that allows management to set a direction in terms of where and how the firm intends to compete, which is then communicated to the firm’s stakeholders.

**EXHIBIT 6-3  Hypothetical Amazon.com SWOT Matrix**

<table>
<thead>
<tr>
<th>Opportunity</th>
<th>Threat</th>
</tr>
</thead>
<tbody>
<tr>
<td>To be perceived by shoppers as the preferred online “department store” and thus exploit accelerating online retail sales.</td>
<td>Walmart, Best Buy, Costco, etc., are increasing their online presence.</td>
</tr>
<tr>
<td><strong>Strengths</strong></td>
<td></td>
</tr>
<tr>
<td>- Brand recognition</td>
<td></td>
</tr>
<tr>
<td>- Convenient online order-entry system</td>
<td></td>
</tr>
<tr>
<td>- Information technology infrastructure</td>
<td></td>
</tr>
<tr>
<td>- Fulfillment infrastructure for selected products (e.g., books)</td>
<td></td>
</tr>
<tr>
<td><strong>Weaknesses</strong></td>
<td></td>
</tr>
<tr>
<td>- Inadequate warehousing and inventory management systems to support rapid sales growth</td>
<td></td>
</tr>
<tr>
<td>- Limited experience in merchandising non-core retail products (e.g., pharmaceuticals, sporting goods)</td>
<td></td>
</tr>
<tr>
<td>- Limited financial resources</td>
<td></td>
</tr>
<tr>
<td>- Substantially smaller retail sales volume limits ability to exploit purchase economies</td>
<td></td>
</tr>
<tr>
<td>- Limited financial resources</td>
<td></td>
</tr>
<tr>
<td>- Limited name recognition in selected markets (e.g., consumer electronics)</td>
<td></td>
</tr>
<tr>
<td>- Retail management depth</td>
<td></td>
</tr>
</tbody>
</table>
in the form of a mission/vision statement and a set of quantifiable financial and nonfinancial objectives.

**DEFINING THE MISSION STATEMENT**

At a minimum, a corporate mission statement seeks to describe the corporation’s purpose for being and where the corporation hopes to go. The mission statement should not be so general as to provide little practical direction. A good mission statement should include references to the firm’s targeted markets, which should reflect the fit between the corporation’s primary strengths and competencies, and its ability to satisfy customer needs better than the competition. It should define the product or service offering, relatively broadly to allow for the introduction of new products that might be derived from the firm’s core competencies. Distribution channels—how the firm chooses to distribute its products—should be identified, as should the customers targeted by the firm’s products and services. The mission statement should state management beliefs with respect to the firm’s primary stakeholders; these beliefs establish the underpinnings of how the firm intends to behave toward those stakeholders.

**Setting Strategic or Long-Term Business Objectives**

What is to be accomplished within a specific period—that is a business objective. A good objective is measurable and has a set time frame in which to be realized. Typical corporate objectives include revenue growth rates, minimum acceptable financial returns, and market share; these objectives and several others are discussed in more detail in the following sections. A good objective might state that the firm seeks to increase revenue from the current $1 billion to $5 billion by a given year. A poorly written objective would simply state that the firm seeks to increase revenue substantially.

**Common Business Objectives**

Corporations typically adopt a number of common business objectives. For instance, the firm may seek to achieve a rate of return that will equal or exceed the return required by its shareholders (cost of equity), lenders (cost of debt), or the combination of the two (cost of capital) by a given year. The firm may set a size objective, seeking to achieve some critical mass defined in terms of sales volume to realize economies of scale by a given year.
Several common objectives relate to growth. Accounting-related growth objectives include seeking to grow earnings per share (EPS), revenue, or assets at a specific rate of growth per year. Valuation-related growth objectives may be expressed in terms of the firm’s common stock price per share divided by earnings per share, book value, cash flow, or revenue.

Diversification objectives are those where the firm desires to sell current products in new markets, new products in current markets, or new products in new markets. For example, the firm may set an objective to derive 25 percent of its revenue from new products by a given year.

It is also common for firms to set flexibility objectives, aiming to possess production facilities and distribution capabilities that can be shifted rapidly to exploit new opportunities as they arise. For example, the major automotive companies have increasingly standardized parts across car and truck platforms to reduce the time required to introduce new products, giving them greater flexibility to facilitate a shift in production from one region to another.

Technology objectives are also common. The firm desires to possess capabilities in core or rapidly advancing technologies. Microchip and software manufacturers, as well as defense contractors, are good examples of industries in which keeping current with, and even getting ahead of, new technologies is a prerequisite for survival.

SELECTING THE APPROPRIATE CORPORATE, BUSINESS, AND IMPLEMENTATION STRATEGIES

Each level of strategy serves a specific purpose. Implementation strategies, necessarily more detailed than corporate-level strategies, provide general guidance for a firm’s business units.

Corporate-Level Strategies

Corporate-level strategies are adopted at the corporate or holding company level and may include all or some of the business units either wholly or partially owned by the corporation. A growth strategy entails a focus on accelerating the firm’s consolidated revenue, profit, and cash-flow growth. This strategy may be implemented in many different ways, as discussed later in this chapter. A diversification strategy involves a decision at the corporate level to enter new businesses. These businesses may be related or completely unrelated to the corporation’s existing business portfolio. An operational restructuring strategy, sometimes called a turnaround or defensive strategy,
usually refers to selling companies or product lines outright or in part, downsizing by closing unprofitable or nonstrategic facilities, obtaining protection from creditors in bankruptcy court, or liquidating assets. A financial restructuring strategy describes actions by the firm to change its total debt and equity structure. The motivation for this strategy may be better utilization of excess corporate cash balances through share-repurchase programs, reducing the firm’s cost of capital by increasing leverage, or increasing management’s control by acquiring a company’s shares through a management buyout.

**Business-Level Strategies**

A firm should choose its business strategy from among the range of reasonable alternatives that enables it to achieve its stated objectives in an acceptable period, subject to resource constraints. They include limitations on the availability of management talent and funds. Gaining access to highly competent management talent is frequently the more difficult of the two to overcome.

Business strategies fall into one of four basic categories: price or cost leadership, product differentiation, focus or niche strategies, or hybrid strategies.

**Price or Cost Leadership**

The price or cost leadership strategy reflects the influence of a series of tools, including the experience curve and product life cycle, introduced and popularized by the Boston Consulting Group (BCG). This strategy is designed to make a firm the cost leader in its market by constructing efficient production facilities, tightly controlling overhead expense, and eliminating marginally profitable customer accounts.

The experience curve postulates that as the cumulative historical volume of a firm’s output increases, cost per unit of output decreases geometrically as the firm becomes more efficient in producing that product. Therefore, the firm with the largest historical output should also be the lowest cost producer. This implies that the firm should enter markets as early as possible and reduce product prices aggressively to maximize market share.

The applicability of the experience curve varies across industries. It seems to work best for largely commodity-type industries in which scale economies can lead to substantial reductions in per unit production costs.

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such as PC or cellphone handset manufacturing. The strategy of continuously driving down production costs may make most sense for the existing industry market share leader. If the leader already has a cost advantage over its competitors because of its significantly larger market share, it may be able to improve its cost advantage by pursuing market share more aggressively through price cutting. This strategy may be destructive if pursued concurrently by a number of firms with approximately the same market share in an industry whose customers see no measurable differences in the products or services offered by the various competitors. Therefore, repetitive price cutting by firms within the industry is likely to drive down profitability for all firms in the industry.

BCG’s second major contribution is the product life cycle, which characterizes a product’s evolution in four stages: embryonic, growth, maturity, and decline. Strong sales growth and low barriers to entry characterize the first two stages. Over time, however, entry becomes more costly as early entrants into the market accumulate market share and experience lower per unit production costs as a result of the effects of the experience curve. New entrants have substantially poorer cost positions thanks to their small market shares compared with earlier entrants, and cannot catch up to the market leaders as overall market growth slows. During the later phases characterized by slow market growth, falling product prices force marginal firms and unprofitable firms out of the market or to consolidate with other firms.

Management can obtain insight into the firm’s probable future cash requirements and, in turn, its value, by determining its position in its industry’s product life cycle. During the high-growth phase, firms in the industry normally have high investment requirements associated with capacity expansion and increasing working capital needs. Operating cash flow is normally negative. During the mature and declining growth phases, investment requirements are lower and cash flow becomes positive.

Although the phases of the product life cycle provide insights into current and future cash requirements for both the acquiring and target companies, determining the approximate length of each phase can be challenging. The introduction of significant product innovation can reinvigorate industry growth and extend the length of the current growth phase. This is particularly true in industries such as microchip, PC, and cellular.

In addition to its applicability to valuing the firm, the product life cycle also can be useful in selecting the firm’s business strategy. In the early stages of the product life cycle, the industry tends to be highly fragmented,
with many participants having very small market shares. Often, firms in the early stages adopt a niche strategy in which they focus their marketing efforts on a relatively small and homogeneous customer group. If economies of scale are possible, the industry will begin to consolidate as firms aggressively pursue cost leadership strategies. That was the situation when, in 2005, Mittal Steel announced a $4.5 billion deal to buy International Steel Group (ISG), a collection of five once-bankrupt steel companies consolidated by U.S. workout specialist Wilbur Ross. The transaction made Mittal the largest steel producer in the world. In a creative application of a cost leadership strategy, Mittal has operated its eight U.S. mills (ISG and three others it already owned)—clustered around the Great Lakes—to achieve “regional” economies of scale. By running the facilities as a single unit, the firm hopes to extract better terms from iron ore, coal, and electricity suppliers. Moreover, Mittal hopes to gain better pricing power with the individual plants no longer competing with each other.

**Product Differentiation**

Differentiation encompasses a range of strategies in which the product offered is perceived by customers to be slightly different from other product offerings in the marketplace. Brand image is one way to accomplish differentiation. Another is to offer customers a range of features or functions. For example, many banks issue MasterCard or Visa credit cards, but each bank tries to differentiate its card by offering a higher credit line, a lower interest rate or annual fee, or awards programs. Software companies justify charging for upgrades based on added features to word-processing or spreadsheet programs that are not found on competing packages. Enhancing technology is a strong differentiator; Apple Computer has used innovative technology to stay ahead of competitors selling MP3 players, most recently with the video capabilities of its newer iPods. Providing alternative distribution channels is another way to differentiate; for example, enabling customers to download products from online sites. Other firms compete on the basis of consistent product quality, by providing excellent service, or by offering customers outstanding convenience. Amazon.com, for instance, offers consumers the opportunity to buy books and other products whenever and from wherever they choose.

**Focus or Niche Strategies**

Firms adopting focus or niche strategies tend to concentrate their efforts by selling a few products or services to a single market, and compete
primarily by understanding their customers’ needs better than does the competition. In the **focus strategy**, the firm seeks to carve a specific niche with respect to a certain group of customers, a narrow geographic area, or a particular use of a product. Examples include the major airlines, airplane manufacturers (e.g., Boeing), and major defense contractors (e.g., Lockheed Martin).

**Hybrid Strategies**

Hybrid strategies involve some combination of the three strategies just discussed (see Exhibit 6-4). For example, Coca-Cola pursues both a differentiated and highly market-focused strategy. The company derives the bulk of its revenues by focusing on the worldwide soft drink market, and its main product is differentiated in that consumers perceive it to have a distinctly refreshing taste. Fast-food industry giant McDonald’s pursues a similarly focused yet differentiated strategy, competing on the basis of providing fast food of a consistent quality in a clean, comfortable environment.

**Implementation Strategies**

After a firm has determined the appropriate business strategy, it must turn its attention to deciding the best means of implementation. This decision involves selecting the right option from a range of reasonable options. Generally, a firm has five choices: implement the strategy based solely on internal resources—the solo venture, go-it-alone, or build approach; partner with others; invest; acquire; or swap assets. Each option has significantly different implications. Exhibit 6-5 compares the advantages and disadvantages of these options.

In theory, the decision to choose among alternative options should be made based on the discounting of the projected cash-flow stream to the firm resulting from each option. In practice, there are many other considerations at work.

**EXHIBIT 6-4 Hybrid Strategies**

<table>
<thead>
<tr>
<th>Cost Leadership</th>
<th>Product Differentiation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Niche/Focus approach</td>
<td>Cisco Systems/WD-40</td>
</tr>
<tr>
<td>Multimarket approach</td>
<td>Walmart/Oracle</td>
</tr>
<tr>
<td></td>
<td>Coca-Cola/McDonald’s</td>
</tr>
<tr>
<td></td>
<td>America Online/Microsoft</td>
</tr>
</tbody>
</table>
The Role of Intangible Factors

Although financial analyses are conducted to evaluate the various implementation strategy options, ultimately the choice may depend on unquantifiable factors such as the senior manager’s risk profile, patience, and ego. The degree of control offered by the various alternatives is often the central issue confronted by senior management as this choice is made. Although the solo venture and acquisition options offer the highest degree of control, they can be the most expensive, although for very different reasons. Typically, a build strategy will take considerably longer to realize key strategic objectives, and it may have a significantly lower current value than the alternatives—depending on the magnitude and timing of cash

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**EXHIBIT 6-5 Implementation Strategies: Solo Venture, Partner, Invest, Acquire, or Asset Swap**

<table>
<thead>
<tr>
<th>Basic Options</th>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Solo venture or build (organic growth)</td>
<td>– Control</td>
<td>– Capital/expense requirements</td>
</tr>
<tr>
<td></td>
<td></td>
<td>– Speed</td>
</tr>
<tr>
<td>Partner (shared growth/shared control)</td>
<td>– Limits capital and expense investment</td>
<td>– Lack of or limited control</td>
</tr>
<tr>
<td></td>
<td>requirements</td>
<td>– Potential for diverging objectives</td>
</tr>
<tr>
<td></td>
<td>– May be precursor to acquisition</td>
<td>– Potential for creating a competitor</td>
</tr>
<tr>
<td>Invest (e.g., minority investments in other</td>
<td>– Limits initial capital/expense requirements</td>
<td>– High risk of failure</td>
</tr>
<tr>
<td>firms)</td>
<td></td>
<td>– Lack of control</td>
</tr>
<tr>
<td>Acquire or merge</td>
<td>– Speed</td>
<td>– Time</td>
</tr>
<tr>
<td></td>
<td>– Control</td>
<td>– Capital/expense requirements</td>
</tr>
<tr>
<td></td>
<td></td>
<td>– Potential earnings dilution</td>
</tr>
<tr>
<td>Swap assets</td>
<td>– Limits use of cash</td>
<td>– Finding willing parties</td>
</tr>
<tr>
<td></td>
<td>– No earnings dilution</td>
<td>– Reaching agreement on assets to be exchanged</td>
</tr>
<tr>
<td></td>
<td>– Limits tax liability if basis in assets</td>
<td></td>
</tr>
<tr>
<td></td>
<td>swapped remains unchanged</td>
<td></td>
</tr>
</tbody>
</table>
flows generated from the investments. Gaining control through acquisition can also be very expensive because of the substantial premium the acquirer normally has to pay to gain a controlling interest in another company.

The joint venture may be a practical alternative to either a build or acquire strategy; it gives a firm access to skills, product distribution channels, proprietary processes, and patents at a lower initial expense than might otherwise be required. The joint venture is frequently a precursor to an acquisition, because it gives both parties time to assess the compatibility of their respective corporate cultures and strategic objectives.

Asset swaps may be an attractive alternative to the other options, but in most industries they are generally very difficult to establish unless the physical characteristics and use of the assets are substantially similar. The practice is relatively common in the commercial and industrial real estate industry. Firms in the cable industry also use asset swaps to achieve strategic objectives. In recent years, cable companies have been swapping customers to allow a single company to dominate a specific geographic area and realize the full benefits of economies of scale.7

**FUNCTIONAL STRATEGIES**

Functional strategies focus on short-term results and generally are developed by functional areas; they also tend to be very detailed and highly structured. These strategies result in a series of concrete actions for each function or business group, depending on the company’s organization. It is common to see separate plans with specific goals and actions for the marketing, manufacturing, R&D, engineering, and financial and human resources functions. Functional strategies should include clearly defined objectives, actions, timetables for achieving those actions, and resources required; they also should identify the individual responsible for ensuring that the actions are completed on time and within budget.

Specific functional strategies might read as follows:

- Set up a product distribution network in the northeastern United States capable of handling a minimum of 1 million units of product

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7 There are many other examples of asset swaps. In 2005, Citigroup exchanged its fund management business for Legg Mason’s brokerage and capital markets businesses, with the difference in the valuation of the businesses paid in cash and stock. Similarly, Royal Dutch Shell and Russia’s Gazprom reached a deal to swap major natural gas–producing properties in late 2005. In 2007, British Petroleum swapped half of its stake in its Toledo, Ohio, oil refinery for half of Husky Energy’s position in the Sunrise oil sands field in Alberta, Canada.
annually by 12/31/20XX. (Individual responsible: Oliver Tran; estimated budget: $5 million.)

- Develop and execute an advertising campaign to support the sales effort in the northeastern United States by 10/31/20XX. (Individual responsible: Maria Gomez; estimated budget: $0.5 million.)

- Hire a logistics manager to administer the distribution network by 9/15/20XX. (Individual responsible: Patrick Petty; estimated budget: $150,000.)

- Acquire a manufacturing company with sufficient capacity to meet the projected demand for the next three years by 6/30/20XX at a purchase price not to exceed $250 million. (Individual responsible: Chang Lee.)

Perhaps an application software company is targeting the credit card industry. Here is an example of how the company’s business mission, business strategy, implementation strategy, and functional strategies are related.

- **Mission**: To be recognized by our customers as the leader in providing accurate, high-speed, high-volume transactional software for processing credit card remittances by 20XX.

- **Business Strategy**: Upgrade our current software by adding the necessary features and functions to differentiate our product and service offering from our primary competitors and satisfy projected customer requirements through 20XX.

- **Implementation Strategy**: Purchase a software company, at a price not to exceed $400 million, capable of developing “state-of-the-art” remittance processing software by 12/21/20XX. (Individual responsible: Donald Stuckee.) (Note that this assumes the firm has completed an analysis of available options, including internal development, collaborating, licensing, or acquisition.)

- **Functional Strategies to Support Implementation Strategy**:
  - Research & Development: Identify and develop new applications for remittance processing software.
  - Marketing & Sales: Assess impact of new product offering on revenue generated from current and new customers.
  - Human Resources: Determine appropriate staffing requirements to support our combined firms.
  - Finance: Identify and quantify potential cost savings generated from improved productivity, as a result of replacing existing software with the newly acquired software, and from the elimination of duplicate personnel in our combined companies. Evaluate the impact of the acquisition on our combined companies’ financial statements.
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- Legal: Ensure that all target company customers have valid contracts and that these contracts are transferable to us without penalty. Also, ensure that we will have exclusive and unlimited rights to use the remittance processing software.
- Tax: Assess the tax impact of the acquisition on our cash flow.

**STRATEGIC CONTROLS**

Strategic controls include both incentive and monitoring systems. *Incentive systems* include bonus, profit sharing, or other performance-based payments made to motivate both acquirer and target company employees to work to implement the business strategy for the combined firms. Typically, these controls would have been agreed to during negotiation. Incentives often include *retention bonuses* for key employees of the target firm if they remain with the combined companies for a specific period following completion of the transaction.

*Monitoring systems* are implemented to track the actual performance of the combined firms against the business plan. They may be accounting based and monitor financial measures such as revenue, profits, and cash flow, or they may be activity based and monitor variables that drive financial performance. These variables include customer retention, average revenue per customer, employee turnover, and revenue per employee.

**THE BUSINESS PLAN AS A COMMUNICATION DOCUMENT**

The necessary output of the planning process is a document that communicates effectively with key decision makers and stakeholders. A good business plan should be short, focused, and well documented. There are many ways to develop such a document. *Exhibit 6-6* outlines the key features that should be addressed in a good business plan—one that is so well reasoned and compelling that decision makers accept its recommendations.

The executive summary may be the most important and difficult piece of the business plan to write. It must communicate succinctly and compellingly what is being proposed, why it is being proposed, how it is to be achieved, and by when. It must also identify the major resource requirements and risks associated with the critical assumptions underlying the plan. The executive summary is often the first and only portion of the business plan that is read by a time-constrained CEO, lender, or venture capitalist. As such, it may represent the first and last chance to catch the attention of the key decision maker.
EXHIBIT 6-6  Key Features of a Typical Business Unit-Level Business Plan

1. Executive summary: In 1–2 pages, describe what you are proposing to do, why, how it will be accomplished, by what date, critical assumptions, risks, and major resource requirements.

2. Industry/market definition: Define the industry/market in which the firm competes in terms of size, growth rate, product offering, and other pertinent characteristics.

3. External analysis: Describe industry/market competitive dynamics in terms of the factors affecting customers, competitors, potential entrants, product/service substitutes, and suppliers and how they interact to determine profitability and cash flow (e.g., Porter or Modified Porter Framework, also known as the Five Forces). Discuss major opportunities and threats that exist because of the industry’s competitive dynamics. This information should be used to develop the assumptions underlying revenue and cost projections in building financial statements.

4. Internal analysis: Describe the company’s strengths and weaknesses and how they compare with the competition. Identify which of these strengths and weaknesses are important to the firm’s targeted customers and explain why. These data can be used to develop cost and revenue assumptions underlying the projected financial statements for the business.

5. Business mission/vision statement: Describe the purpose of the corporation, what it intends to achieve, and how it wishes to be perceived by its stakeholders. For example, an automotive parts manufacturer may envision itself as being perceived, by decade’s end, as the leading supplier of high-quality components worldwide by its customers and as fair and honest by its employees, the communities in which it operates, and its suppliers.

6. Quantified strategic objectives (including completion dates): Indicate both financial goals (e.g., rates of return, sales, cash flow, share price) and nonfinancial goals (e.g., market share; being perceived by customers or investors as number one in the targeted market in terms of market share, product quality, price, innovation).

7. Business strategy: Identify how the mission and objectives will be achieved (e.g., become a cost leader, adopt a differentiation strategy, focus on a specific market segment, or some combination of these strategies). Show how the chosen business strategy satisfies a key customer need or builds on a major strength of the firm. (For example, a firm whose targeted customers are highly price sensitive may pursue a cost leadership strategy to enable it to lower selling prices and to increase market share and profitability. Alternatively, a firm with a well-established brand name may choose to

(Continued)
EXHIBIT 6-6 (Continued)

pursue a differentiation strategy by adding features to its product that are perceived by its customers as valuable.)

8. Implementation strategy: From a range of reasonable options (i.e., solo venture or “go it alone” strategy; partner via a joint venture or less formal business alliance, license, or minority investment; or acquire/merge), indicate which option would enable the firm to best implement its chosen business strategy. State why the chosen implementation strategy is superior to other options. (For example, an acquisition strategy may be appropriate if the perceived “window of opportunity” is believed to be brief. Alternatively, a solo venture may be preferable if there are few attractive acquisition opportunities or if the firm believes that it has the necessary resources to develop the needed processes or technologies.)

9. Functional tactical strategies: Identify plans and resources required by major functional areas, including manufacturing, engineering, sales and marketing, research and development, finance, legal, and human resources.

10. Business plan financials and valuation: Provide projected five-year income, balance sheet, and cash flow statements for the firm and estimate the firm’s value based on the projected cash flows. State key forecast assumptions underlying the projected financials and valuation.

11. Risk assessment: Evaluate the potential impact on valuation by changing selected key assumptions one at a time. Briefly identify contingency plans (i.e., alternative ways of achieving the firm’s mission/objectives) that would be undertaken if critical assumptions prove inaccurate. Identify specific events that would cause the firm to pursue a contingency plan. Such “trigger points” could include deviations in revenue growth of more than x percent or the failure to acquire or develop a needed technology within a specific period.

Supporting documentation should be referred to in the business plan text but presented in appendices.

* * *

The success of an acquisition is frequently dependent on the focus, understanding, and discipline inherent in a thorough and viable business plan that addresses four overarching questions: Where should the firm compete? How should the firm compete? How can the firm satisfy customer needs better than the competition? Why is the chosen strategy preferable to other reasonable options?
An acquisition is only one of many options available for implementing a business strategy. The decision to pursue an acquisition often rests on the desire to achieve control and a perception that the acquisition will result in achieving the desired objectives more rapidly than other options. All too often, firms pay far too much for control. Alternative options may prove to be less risky. A firm may choose to implement what amounts to a phased acquisition by first entering into a joint venture with another company before acquiring it at a later date.

Once a firm has decided that an acquisition is critical to realizing the strategic direction defined in the business plan, a merger/acquisition plan should be developed. That is the subject of the next chapter.

A Case in Point: Nokia Moves to Establish Industry Standards
The ultimate success or failure of any transaction to satisfy expectations often is heavily dependent on the answer to a simple question. Was the justification for buying the target firm based on a sound business strategy? A bad strategy may be bold, innovative, or precedent setting, but it is still a bad strategy.

In a bold move reminiscent of the rollout of Linux, the Finnish phone handset manufacturer Nokia announced in mid-2008 that it had reached an agreement to acquire Symbian, its supplier of smartphone operating system software. When the transaction was completed, Symbian supplied 56 percent of the operating system software for smartphones.

In its vision for the future, Nokia seems to be positioning itself as the premier supplier of online services to the smartphone market, hoping to establish an industry standard based on the Symbian software to use as a platform. Such services could include online music and photo sharing. By providing the Symbian code at no cost, Nokia hopes that more independent software developers will make their service offering compatible with the Symbian system. Microsoft is likely to be hurt by these developments because it charges royalties to use its software.

Nokia’s business strategy or model is to dominate the smartphone market with handsets that rely on the Symbian operating system—a strategy that relies heavily on the company’s ability to grow its base of customers who use Nokia-supplied handsets capable of downloading online services. The firm hopes to move from more expensive niche products, such as its N series handsets, to less-expensive, mass-market products. Nokia hopes to exploit economies of scale by spreading any fixed cost associated with online services over an expanding customer base. Such fixed expenses could include a requirement by content service providers that Nokia pay a minimum level of royalties in addition to royalties...
Developing the Business Plan as the Initial Phase of the Merger and Acquisition Process

that vary with usage. Similarly, the development cost incurred by service providers can be defrayed by selling to a growing customer base.

At present, many handsets that are in wide use employ proprietary operating software, which makes it difficult to provide online services. Nokia’s implementation strategy is to acquire the leading supplier of handset operating systems and to subsequently give away the Symbian software free.

The opportunity has not been lost on Nokia competitors. Google is backing an operating system called Android to create a Web-friendly software platform, and at this writing has rolled out several Android-based phones, including the Motorola Droid series offered by Verizon. The LiMo Foundation has garnered widespread support for using Linux software for mobile phones. The widespread popularity of Apple’s iPhone has captured the imagination of many independent software developers targeting the smartphone as a conduit for distributing online services to consumers.

The success or failure of Nokia’s vision, business strategy, and implementation strategy will depend on whether Symbian can do a better job of recruiting other handset makers, service providers, and consumers than Nokia’s competitors. Nokia may have been too optimistic because its success in establishing an industry operating system standard depends on its ability to enlist the support of other manufacturers of handsets who may be understandably reluctant to do anything that would strengthen a competitor. One projection is that Nokia’s share of the smartphone operating system market will decline to 45 percent in 2012, with Google’s then accounting for 18 percent. Many smartphone manufacturers already are hedging their bets. For example, although Motorola and NTT DoCoMo will serve on the Symbian board, they also are involved in various ways with LiMo and Android.

**Things to Think About:**
1. What are the key assumptions implicit in Nokia’s business strategy, and are they reasonable?
2. What are the key assumptions implicit in Nokia’s implementation strategy, and are they reasonable?
3. How does Nokia intend to make money as a result of these strategies? Be specific.
4. How are Nokia’s competitors reacting to its strategy? Why?
5. What options does Nokia have if its strategy is unsuccessful? Be specific.

Answers can be found at: www.elsevierdirect.com/companion.jsp?ISBN=9780123749482

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8 Gartner, Inc.
The Role of the Acquisition Plan, Finding a Target, and Making First Contact

Chapter 6 discussed in some detail the role of a firm’s business plan in providing a mission or direction, measurable financial and nonfinancial objectives to measure progress, and the business strategy for realizing the firm’s mission and objectives. If a firm decides to execute its strategy through an acquisition, it will need an acquisition plan. Here, you will learn the steps of the acquisition planning process, including detailed components of an acquisition plan, how to conduct an effective search process, and how to make initial contact with a potential target firm. (Note that if the implementation of the firm’s business strategy required some other business combination, such as a joint venture or business alliance, the same logic of the acquisition planning process described here would apply.)

The acquisition plan is a specific type of implementation strategy that focuses on tactical or short-term issues rather than strategic or longer-term issues. It includes management objectives, a resource assessment, a market analysis, senior management’s preferences regarding management of the acquisition process, a timetable, and the name of the individual responsible for making it all happen. These and the criteria to use when searching acquisition targets are codified in the first part of the planning process; after a target has been identified, there are several additional steps, including contacting the target, developing a negotiation strategy, determining the initial offer price, and developing both financing and integration plans. Exhibit 7-1 illustrates the entire process.

Development of the acquisition plan should be directed by the “deal owner”—typically a high-performing manager accountable for the specific acquisition. Senior management should, very early in the process, appoint the deal owner to this full- or part-time position. It can be someone in the firm’s business development unit, for example, or a member of the firm’s business development team with substantial deal-making experience. Often, it is the individual who will be responsible for the operation and integration of the target, with an experienced dealmaker playing a supporting role.
PRE-TARGET SELECTION

The first steps in the acquisition planning process involve codifying the plan elements that are necessary before the search for an acquisition target can begin.

Plan Objectives

The acquisition plan’s stated objectives should be completely consistent with the firm’s strategic objectives. Financial and nonfinancial objectives alike should support realization of the business plan objectives. Moreover, as is true with business plan objectives, the acquisition plan objectives should be quantified and include a date when such objectives are expected to be realized.

Financial objectives in the acquisition plan could include targets for a minimum rate of return or operating profit, revenue, and cash flow to be achieved within a specified period. Minimum or required rates of return targets may be substantially higher than those specified in the business plan, which relate to the required return to shareholders or to total capital (i.e., debt plus equity). The required return for the acquisition may reflect a substantially higher level of risk as a result of the perceived variability of the amount and timing of the expected cash flows resulting from the acquisition.

EXHIBIT 7-1 Acquisition Planning Steps

<table>
<thead>
<tr>
<th>Pre-Target Selection</th>
</tr>
</thead>
<tbody>
<tr>
<td>Step 1: Develop plan objectives</td>
</tr>
<tr>
<td>Step 2: Establish timetable for completing the transaction</td>
</tr>
<tr>
<td>Step 3: Evaluate acquirer resources and capabilities</td>
</tr>
<tr>
<td>Step 4: Determine management preferences</td>
</tr>
<tr>
<td>Step 5: Develop search plan</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Post-Target Selection</th>
</tr>
</thead>
<tbody>
<tr>
<td>Step 6: Develop negotiation strategy</td>
</tr>
<tr>
<td>Step 7: Determine initial offer price</td>
</tr>
<tr>
<td>Step 8: Develop financing plan</td>
</tr>
<tr>
<td>Step 9: Develop integration plan</td>
</tr>
</tbody>
</table>
Nonfinancial objectives address the motivations for making the acquisition that support the achievement of the financial returns stipulated in the business plan. They could include obtaining rights to specific products, patents, copyrights, or brand names; providing growth opportunities in the same or related markets; developing new distribution channels in the same or related markets; obtaining additional production capacity in strategically located facilities; adding R&D capabilities; and acquiring access to proprietary technologies, processes, and skills. Because these objectives identify the factors that ultimately determine whether a firm will achieve its desired financial returns, they may provide substantially more guidance than financial targets.

Exhibit 7-2 illustrates how these and other acquisition plan objectives can be linked with business plan objectives. Note that both business and acquisition plan objectives are quantified and have associated completion dates.

### EXHIBIT 7-2 Examples of Linkages between Business and Acquisition Plan Objectives

<table>
<thead>
<tr>
<th>Business Plan Objective</th>
<th>Acquisition Plan Objective</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial: The firm will</td>
<td>Financial returns: The target firm should have</td>
</tr>
<tr>
<td>Achieve rates of return that will equal or exceed its cost of equity or capital by 20XX.</td>
<td>A minimum return on assets of x%.</td>
</tr>
<tr>
<td>Maintain a debt/total capital ratio of x%.</td>
<td>A debt/total capital ratio ( \leq y% ).</td>
</tr>
<tr>
<td></td>
<td>Unencumbered assets of $z$ million.</td>
</tr>
<tr>
<td></td>
<td>Cash flow in excess of operating requirements of $x$ million.</td>
</tr>
<tr>
<td>Size: The firm will</td>
<td>Size: The target firm should have at least $x$ million in revenue.</td>
</tr>
<tr>
<td>Be the number-one or -two market share leader by 20XX.</td>
<td></td>
</tr>
<tr>
<td>Achieve revenue of $x$ million by 20XX.</td>
<td></td>
</tr>
<tr>
<td>Growth: The firm will achieve through 20XX annual average</td>
<td>Growth: The target firm should have</td>
</tr>
<tr>
<td>Revenue growth of x%.</td>
<td>Have annual revenue, earnings, and</td>
</tr>
<tr>
<td>Earnings per share growth of y%.</td>
<td>operating cash-flow growth of at least x%, y%, and z%.</td>
</tr>
<tr>
<td>Operating cash-flow growth of z%.</td>
<td>Provide new products and markets.</td>
</tr>
<tr>
<td>Diversification: The firm will reduce earnings variability by x%.</td>
<td>Possess excess annual production capacity of $x$ million units.</td>
</tr>
<tr>
<td></td>
<td>Diversification: The target firm’s earnings should be largely uncorrelated with the acquirer’s earnings.</td>
</tr>
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1 DePamphilis (2001).
Resource/Capability Evaluation

Early in the acquisition process, it is important to determine the maximum amount of the firm’s available resources senior management will commit to a merger or acquisition. This information is used when the firm develops target selection criteria before undertaking a search for target firms.

Financial resources potentially available to the acquirer include those provided by internally generated cash flow in excess of normal operating requirements, plus funds from the equity and debt markets. In cases where the target firm is known, the potential financing pool includes funds provided by the internal cash flow of the combined companies in excess of normal operating requirements, the capacity of the combined firms to issue equity or increase leverage, and the proceeds from selling assets not required for implementing the acquirer’s business plan.

Financial theory suggests that an acquiring firm will always be able to attract sufficient funding for an acquisition if it can demonstrate that it can

<table>
<thead>
<tr>
<th>Business Plan Objective</th>
<th>Acquisition Plan Objective</th>
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<tbody>
<tr>
<td>Flexibility: The firm will achieve flexibility in manufacturing and design.</td>
<td>Flexibility: The target firm should use flexible manufacturing techniques.</td>
</tr>
<tr>
<td>Technology: The firm will be recognized by its customers as the industry’s technology leader.</td>
<td>Technology: The target firm should possess important patents, copyrights, and other forms of intellectual property.</td>
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<tr>
<td>Quality: The firm will be recognized by its customers as the industry’s quality leader.</td>
<td>Quality: The target firm’s product defects must be $&lt;x$ per million units manufactured.</td>
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<tr>
<td>Service: The firm will be recognized by its customers as the industry’s service leader.</td>
<td>Warranty record: The target firm’s customer claims per million units sold should be not greater than $x$.</td>
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<tr>
<td>Cost: The firm will be recognized by its customers as the industry’s low-cost provider.</td>
<td>Labor costs: The target firm should be nonunion and not subject to significant government regulation.</td>
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<tr>
<td>Innovation: The firm will be recognized by its customers as the industry’s innovation leader.</td>
<td>R&amp;D capabilities: The target firm should have introduced at least $x$ new products in the last 18 months.</td>
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earn its cost of capital. In practice, senior management’s risk tolerance plays an important role in determining what the acquirer believes it can afford to spend on a merger or acquisition. Consequently, risk-averse management may be inclined to commit only a small portion of the total financial resources potentially available to the firm.

Three basic types of risk confront senior management considering an acquisition and affect how management feels about the affordability of an acquisition opportunity. How these risks are perceived will determine how much of potential available resources management will be willing to commit to making an acquisition.

**Operating risk** addresses the ability of the buyer to manage the acquired company. Generally, it is perceived to be higher for M&As in markets unrelated to the acquirer’s core business. The limited understanding of managers in the acquiring company of the competitive dynamics of the new market and the inner workings of the target firm may negatively affect the postmerger integration effort as well as the ongoing management of the combined companies.

**Financial risk** refers to the buyer’s willingness and ability to leverage a transaction, as well as the willingness of shareholders to accept dilution of near-term earnings per share (EPS). To retain a specific credit rating, the acquiring company must maintain certain levels of financial ratios such as debt-to-total capital and interest coverage (i.e., earnings before interest and taxes divided by interest expense). A firm’s incremental debt capacity can be approximated by comparing the relevant financial ratios to those of comparable firms in the same industry that are rated by the credit rating agencies. The difference represents the amount the firm, in theory, could borrow without jeopardizing its current credit rating. Senior management could also gain insight into how much EPS dilution equity investors may be willing to tolerate through informal discussions with Wall Street analysts and an examination of comparable transactions financed by issuing stock.

**Overpayment risk** involves the dilution of EPS or a reduction in its growth rate resulting from paying significantly more than the economic

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2 For example, suppose the combined acquirer and target firms’ interest coverage ratio is 3 and the combined firms’ debt-to-total capital ratio is 0.25. Assume further that other firms within the same industry with comparable interest coverage ratios have debt-to-total capital ratios of 0.5. Consequently, the combined acquirer and target firms could increase borrowing without jeopardizing their combined credit rating until their debt-to-total capital ratio equals 0.5.
value of the acquired company. The effects of overpayment on earnings dilution can last for years.³

**Management Preferences**

Senior management’s preferences for conducting the acquisition process are usually expressed in terms of boundaries or limits. To ensure that the process is managed in a manner consistent with management’s risk tolerance and biases, management must provide guidance to those responsible for finding and valuing the target, as well as negotiating the transaction. Substantial upfront participation by management will help dramatically in the successful implementation of the acquisition process. Unfortunately, senior management frequently avoids providing significant input early in the process. This inevitably leads to miscommunication, confusion, and poor execution later in the process.

*Exhibit 7-3* provides examples of the more common types of management guidance that might be found in an acquisition plan.

**Timetable**

The final component of a properly constructed acquisition plan is a schedule that recognizes all of the key events that must take place in the acquisition process. Each event should have beginning and ending dates and milestones along the way, and should identify who is responsible for ensuring that each milestone is achieved. The timetable of events should be aggressive but realistic. The timetable should be sufficiently aggressive to motivate all involved to work as expeditiously as possible to meet the plan’s management objectives, while also avoiding overoptimism that may demotivate individuals if uncontrollable circumstances delay reaching certain milestones.

**Searching for Potential Acquisition Targets**

In the pre-target selection phase of acquisition planning, the first step in searching for potential acquisition candidates is to establish a relatively

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³ To illustrate the effects of overpayment risk, assume the acquiring company’s shareholders are satisfied with the company’s projected annual average increase in EPS of 20 percent annually for the next five years. The company announces it will be acquiring another company and that a series of “restructuring” expenses will slow EPS growth in the coming year to 10 percent. However, management argues that the savings resulting from combining the two companies will raise the combined companies’ EPS growth rate to 30 percent in the second through fifth year of the forecast. The risks are that the savings cannot be realized in the time assumed by management and the slowdown in earnings extends well beyond the first year.
The Role of the Acquisition Plan, Finding a Target, and Making First Contact

A small number of primary screening or selection criteria. These criteria should include the industry and size of the transaction, which is best defined in terms of the maximum purchase price a firm is willing to pay. This can be expressed as a maximum price-to-earnings, book, cash flow, or revenue ratio, or a maximum purchase price stated in terms of dollars. It also may be appropriate to add a geographic restriction to the selection criteria.

Consider a private acute-care hospital holding company that wants to buy a skilled nursing facility within 50 miles of its largest hospital in Allegheny County, Pennsylvania. Management believes it cannot afford to pay more than $45 million for the facility. Its primary selection criteria could include an industry (skilled nursing), location (Allegheny County), and maximum price (5 times cash flow not to exceed $45 million).

Similarly, a Texas-based manufacturer of patio furniture with manufacturing operations in the southwestern United States seeks to expand its sales in California. The company decides to seek a patio furniture

**EXHIBIT 7-3  Examples of Management Guidance Provided to Acquisition Teams**

1. Determining the criteria used to evaluate prospective candidates (e.g., size, price range, current profitability, growth rate, geographic location, and cultural compatibility).
2. Specifying acceptable methods for finding candidates (e.g., soliciting board members; analyzing competitors; and contacting brokers, investment bankers, lenders, law firms, and the trade press).
3. Establishing roles and responsibilities of the acquisition team, including the use of outside consultants, and defining the team's budget.
4. Identifying acceptable sources of financing (e.g., equity issues, bank loans, unsecured bonds, seller financing, or asset sales).
5. Establishing preferences for an asset or stock purchase and form of payment (cash, stock, or debt).
6. Setting a level of tolerance for goodwill.
7. Indicating the degree of openness to partial rather than full ownership.
8. Specifying willingness to launch an unfriendly takeover.
9. Setting affordability limits (which can be expressed as a maximum price to after-tax earnings, earnings before interest and taxes, or cash flow multiple or maximum dollar amount).
10. Indicating any desire for related or unrelated acquisitions.
manufacturer that it can purchase for no more than $100 million. Its primary selection criteria could include an industry (outdoor furniture), a location (California, Arizona, and Nevada), and a maximum purchase price (15 times after-tax earnings not to exceed $100 million).

The second pre-target selection step is to develop a search strategy that employs the selection criteria. This strategy typically involves using computerized databases and directory services such as Disclosure, Dun & Bradstreet’s Million Dollar Database, Standard & Poor’s Corporate Register and Capital IQ, or Thomas’ Register to identify qualified candidates. Firms also may query their law, banking, and accounting firms to identify other candidates. Investment banks, brokers, and leveraged buyout firms are also fertile sources of potential candidates, although they are likely to require an advisory or finder’s fee.

The Internet makes research much easier than in the past; today, analysts have much more information at their fingertips than ever before. Such services as Google Finance, Yahoo! Finance, Hoover’s, or EDGAR Online enable researchers to gather data quickly about competitors and customers. These sites provide easy access to a variety of public documents filed with the Securities and Exchange Commission.

If confidentiality is not an issue, a firm may seek to advertise its interest in acquiring a particular type of firm in The Wall Street Journal or trade press. Although this tactic is likely to generate substantial interest, it is less likely to generate high-quality prospects. Rather, there are likely to be a lot of responses from those interested in getting a free valuation of their own company, brokers claiming their clients fit the buyer’s criteria as a ruse to convince you that you need the broker’s services, and other wastes of time.

Finding reliable information about privately owned firms is a major problem. Sources such as Dun & Bradstreet or Experian may provide only fragmentary data. Publicly available information may offer additional detail. For example, surveys by trade associations or the U.S. Census Bureau often include industry-specific average sales per employee. A private firm’s sales can be estimated by multiplying this figure by an estimate of the firm’s workforce, which may be obtained by searching the firm’s product literature, website, or trade show speeches, or even by counting the number of cars in the parking lot.

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4 It is important to respond in writing if you receive a solicitation from a broker or finder, particularly if you reject these services. If, at a later date, you acquire the firm that the broker or finder claims to have represented, he or she may sue your firm for compensation.
Increasingly, companies—even mid-size firms—are moving investment banking “in-house.” Rather than use brokers or so-called finders\(^5\) as part of their acquisition process, they are identifying potential targets, doing valuation, and performing due diligence on their own. This reflects efforts to save on investment banking fees, which can easily be more than $5 million plus expenses on a $500 million transaction.\(^6\)

**Screening the Initial Search Results**

The screening process is a refinement of the search process. It begins by pruning the initial list of potential candidates created using the primary criteria discussed earlier. Because relatively few primary criteria are used, the initial list may be lengthy. It can be shortened using secondary selection criteria, but care should be taken to limit the number of these criteria. An excessively long list of selection criteria will severely limit the number of candidates that pass the screening process.

Secondary selection criteria may include a specific market segment within the industry identified as a primary selection criterion, or a specific product line within a market segment. Other criteria may include the firm’s profitability, degree of leverage, and market share. Cultural compatibility also should be considered as an important screening criterion. The selection criteria should be quantifiable, whenever possible.

**Market Segment**

The search process involved the specification of the target industry and perhaps resulted in a lengthy list of acquisition candidates. The list can be

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5. A broker has a fiduciary responsibility to either the potential buyer or seller and is not permitted to represent both parties. Compensation is paid by the client to the broker. Some states license brokers. A finder is someone who introduces both parties but represents neither party. The finder has no fiduciary responsibility to either party and is compensated either by one or both parties. Generally, finders are not licensed. (It can be challenging to determine whether an agent is a broker or a finder; courts often identify a finder as a broker if the finder discusses price or any significant terms of the transaction.) If you choose to use a broker or finder, make sure the fees and terms are clearly stipulated in writing. Keep a written record of all telephone conversations and meetings with the finder or broker. These may be used in court at a later date if the broker or finder sues for fees that may be in dispute.

6. Actual fee formulas are most often based on the purchase price. The so-called Lehman formula was at one time a commonly used fee structure in which broker or finder fees would be equal to 5 percent of the first $1 million of the purchase price, 4 percent of the second, 3 percent of the third, 2 percent of the fourth, and 1 percent of the remainder. Today, this formula is often ignored in favor of a negotiated fee structure consisting of a basic fee (or retainer) paid regardless of whether the deal is consummated, an additional closing fee paid on closing, and an “extraordinary” fee paid under unusual circumstances that may delay eventual closing, such as gaining antitrust approval or achieving a hostile takeover. Fees vary widely, but 1 percent of the total purchase price plus reimbursement of expenses is often considered reasonable. For small deals, investment bankers often insist on the Lehman formula.
shortened by identifying a target segment within the industry. For example, a steel fabrication company may decide to diversify by acquiring a manufacturer of aluminum flat-rolled products. Whereas the primary search criterion might have been any firms in the aluminum flat-rolled products industry, a secondary criterion could stipulate a segmenting of the market to identify only those companies that manufacture aluminum tubular products.

**Product Line**
The product line criterion identifies a specific product line within the target market segment. For example, the same steel fabrication company may decide to focus its search on companies manufacturing aluminum tubular products used for lawn and patio furniture.

**Profitability**
The profitability criterion should be defined in terms of the percentage return on sales, assets, or total investment. This definition allows a more accurate comparison among candidates of different sizes. A firm with after-tax earnings of $5 million on sales of $100 million may be less attractive than a firm earning $3 million on sales of $50 million because the latter firm may be more efficient.

**Degree of Leverage**
Debt-to-equity or debt-to-total capital ratios are used to measure the level of leverage or indebtedness. The acquiring company may not want to purchase a company whose heavy debt burden may cause the combined company’s leverage ratios to jeopardize its credit rating.

**Market Share**
The acquiring firm may be interested only in firms that are number one or two in market share in the targeted industry, or in firms whose market share is some multiple (e.g., $2 \times$ the next largest competitor). Firms having substantially greater market share than their competitors often are able to achieve lower cost positions than their competitors because of economies of scale and experience curve effects.

**Cultural Compatibility**
Although cultural compatibility between the acquirer and the target may be more difficult to quantify than other measures, public statements about the target’s vision for the future and its governance practices, as well as
its reputation as a responsible corporate citizen within its industry, will provide some subjective measure. Insights can be gained by examining employee demographics, such as the approximate average age and diversity of the workforce, and how long the potential target has been in business. America Online’s 2001 acquisition of Time Warner highlighted how difficult it can be to integrate a young, heterogeneous employee population with a much older, more homogeneous group. Also, as a much newer firm, AOL had a much less structured management style than was found in Time Warner’s more staid environment. Finally, an acquirer needs to determine whether it can adapt to the challenges of dealing with foreign firms, such as different languages and customs.

**CONTACTING THE SELECTED TARGET**

Using both the primary and secondary selection criteria makes it possible to bring the search to a close and begin the next part of the acquisition planning process. This process begins with contacting the selected target company. The subsequent steps—developing a strategy for negotiations, determining an initial offer price, and developing financing and integration plans—are discussed in Chapters 8, 9, and 10.

**First Contact**

The approach for initiating contact with a target company depends on the size of the company, whether the target is publicly or privately held, and the acquirer’s time frame for completing a transaction. The time frame can be extremely important. If time permits, there is no substitute for developing a personal relationship with the sellers—especially if theirs is a privately held firm. Developing a rapport often makes it possible to acquire a company that is not thought to be for sale.

Personal relationships must be formed only at the highest levels within a privately held target firm. Founders or their heirs often have a strong paternalistic view of these businesses, whether they are large or small. Such firms often have great flexibility in negotiating a deal that “feels right,” rather than simply holding out for the highest possible price. In contrast, personal relationships can go only so far in negotiating with a public company that has a fiduciary responsibility to its shareholders to get the best price.

If time is a critical factor, acquirers may not have the luxury of developing close personal relationships with the seller. Under these circumstances, a more expeditious approach must be taken.
**Small Companies**
For small companies (<$25 million in sales) with which the buyer has no direct contacts, it may only be necessary to initiate contact through a vaguely worded letter expressing interest in a joint venture or marketing alliance. During the follow-up telephone call, be prepared to discuss a range of options with the seller.

Preparation before the first telephone contact is essential. If possible, script your comments. Get to the point quickly but indirectly. Identify yourself, your company, and its strengths. Demonstrate your understanding of the contact’s business and how an informal partnership could make sense. Be able to explain the benefits of your proposal to the contact, quickly and succinctly. If the opportunity arises, propose a range of options, including an acquisition. Listen carefully to the contact’s reaction. If the contact is willing to entertain the notion of an acquisition, request a face-to-face meeting.\(^7\)

**Medium-Size Companies**
For medium-size companies (between $25 and $100 million), use an intermediary to make contact at the highest level possible in the target firm’s organization. Intermediaries include members of the acquirer’s board of directors or the firm’s outside legal counsel, accounting firm, lender, broker/finder, or investment banker. Using intermediaries can be less intimidating than taking a direct approach.

**Large Companies**
For large, publicly traded companies, contact also should be made through an intermediary, at the highest level possible. Discretion is extremely important because of the target’s concern about being “put into play”—that is, when circumstances suggest that it may be an attractive investment opportunity for other firms. Even rumors of an acquisition can have substantial, adverse consequences for the target. Current or potential customers may express concern about the uncertainty associated with a change of

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\(^7\) To ensure confidentiality, choose a meeting place that provides sufficient privacy. Create a written agenda for the meeting after soliciting input from all participants. The meeting should start with a review of your company and your perspective on the outlook for the industry. Encourage the potential target firm to provide information on its own operations and its outlook for the industry. Look for areas of consensus.
ownership. Such a change could imply variation in product or service quality, reliability, and the level of service provided under product warranty or maintenance contracts. Suppliers worry about possible disruptions in their production schedules as the transition to the new owner takes place. Employees worry about possible layoffs or changes in compensation. Competitors will do what they can to fan these concerns in an effort to persuade current customers to switch and potential customers to defer buying decisions; key employees will be encouraged to defect to the competition. Shareholders may experience a dizzying ride as arbitrageurs, buying on the rumor, bid up the price of the stock only to bail out if denial of the rumor appears credible.

**Discussing Value**

Neither the buyer nor seller has any incentive to be the first to provide an estimate of value. It is difficult to back away from a number put on the table by either party, should new information emerge. Getting a range may be the best you can do.

Discussing values for recent acquisitions of similar businesses is one way to get a range. Another is to agree to a formula for calculating the purchase price. For example, the purchase price may be defined in terms of a price to current year earnings multiple. This way, both parties are able to proceed to performing due diligence to reach a consensus on the actual current year’s earnings for the target firm.

**Preliminary Legal Documents**

Typically, and early on, parties to M&A transactions negotiate a confidentiality agreement, term sheet, and letter of intent.

**Confidentiality Agreement**

All parties to the deal are likely to want a *confidentiality agreement* (also called a nondisclosure agreement), which is generally mutually binding; that is, it covers all parties to the transaction. In negotiating the confidentiality agreement, the buyer requests as much audited historical data and supplemental information as the seller is willing to provide. The prudent seller requests similar information about the buyer to assess the buyer’s financial credibility. It is important for the seller to determine the buyer’s credibility early in the process so as not to waste time with a potential buyer incapable of raising the financing to complete the transaction.
The agreement should cover only information that is not publicly available and should have a reasonable expiration date. Note that the confidentiality agreement can be negotiated independently or as part of the term sheet or letter of intent.

**Term Sheet**

A *term sheet* outlines the primary terms with the seller and is often used as the basis for a more detailed letter of intent. Involving lawyers and accountants may not be necessary at this stage. It is the last point before the parties to the potential transaction start incurring significant legal, accounting, and consulting expenses.

A standard term sheet is typically two- to four-pages long and stipulates the total consideration or purchase price (often as a range), what is being acquired (i.e., assets or stock), limitations on the use of proprietary data, a *no-shop agreement* preventing the seller from sharing the terms of the buyer’s proposal with other potential buyers with the hope of instigating an auction environment, and a termination date. Many transactions skip the term sheet and go directly to negotiating a letter of intent.

**Letter of Intent**

Unlike the confidentiality agreement, not all parties to the transaction may want a letter of intent (LOI). Although the LOI can be useful in identifying areas of agreement and disagreement early in the process, the rights of all parties to the transaction, and certain protective provisions, it may delay the signing of a definitive agreement of purchase and sale and may also result in some legal risk to either the buyer or seller if the deal is not consummated. Public companies that sign a letter of intent for a transaction likely to have a “material” impact on the buyer or seller may need to announce the LOI publicly to comply with securities law.

The LOI formally stipulates the reason for the agreement and major terms and conditions. It also indicates the responsibilities of both parties while the agreement is in force, a reasonable expiration date, and how all fees associated with the transaction will be paid. Major terms and conditions include a brief outline of the structure of the transaction, which may entail the payment of cash or stock for certain assets and the assumption of certain target company liabilities. The letter may also specify certain conditions, such as an agreement that selected personnel of the target will not compete with the combined companies for some period should they leave. Another condition may indicate that a certain portion of the purchase
price will be allocated to the noncompete agreement. Such an allocation of the purchase price is in the interests of the buyer because the amount of the allocation can be amortized over the life of the agreement. As such, it can be taken as a tax-deductible expense. However, it may constitute taxable income for the seller. The agreement also may place a portion of the purchase price in escrow.

The proposed purchase price may be expressed as a specific dollar figure, as a range, or as a multiple of some measure of value, such as operating earnings or cash flow. The LOI also specifies the types of data to be exchanged and the duration and extent of the initial due diligence. The LOI usually will terminate if the buyer and the seller do not reach agreement by a certain date. Legal, consulting, and asset transfer fees (i.e., payments made to governmental entities when ownership changes hands) may be paid for by the buyer or seller, or they may be shared.

Depending on how the LOI is written, it may or may not be legally binding. A well-written LOI usually contains language limiting the extent to which the agreement binds the two parties. Price or other provisions are generally subject to closing conditions, such as the buyer having full access to all of the seller’s books and records; having completed due diligence; obtaining financing; and having received approval from boards of directors, stockholders, and regulatory bodies. Other standard conditions include requiring signed employment contracts for key target firm executives and the completion of all necessary M&A documents. Failure to satisfy any of these conditions will invalidate the agreement. A well-written LOI should also describe the due diligence process in some detail. It should stipulate how the potential buyer should access the potential seller’s premises, the frequency and duration of such access, and how intrusive such activities should be. The LOI should indicate how the buyer should meet and discuss the deal with the seller’s employees, customers, and suppliers. Sometimes the provisions of a standard confidentiality agreement are negotiated as part of the LOI. The letter of intent becomes the governing document for the deal that the potential acquirer can show to prospective financing sources.

The LOI may create legal liabilities if one of the parties is later accused of not negotiating in “good faith.” This is the basis for many lawsuits filed when transactions are undertaken but not completed as a result of disagreements that emerge during lengthy and often heated negotiations.

In recent years, some letters of intent have included go-shop provisions, which allow the seller to continue to solicit higher bids for several months.
However, if the seller accepts another bid, the seller would have to pay a breakup fee to the bidder with whom it has a signed agreement.

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Exhibit 7-4 recaps the components of a typical acquisition planning process as discussed in this chapter. Negotiation, the offer price, financing, and integration are the subject of the next chapters.

### EXHIBIT 7-4 Acquisition Planning for the Acquiring Firm

1. **Plan objectives:** Identify the specific purpose of the acquisition, including the specific goals to achieve (e.g., cost reduction; access to new customers, distribution channels, or proprietary technology; expanded production capacity) and **how achieving the goals will better enable the acquiring firm to implement its business strategy.**

2. **Resource/capability evaluation:** Evaluate the acquirer’s financial and managerial capability to complete an acquisition. Identify affordability limits in terms of the maximum amount the acquirer should pay for an acquisition. Explain how this figure is determined.

3. **Management preferences:** Indicate the acquirer’s preferences for a “friendly” acquisition; controlling interest; using stock, debt, cash, or some combination; etc.

4. **Timetable:** Establish a timetable for completing the acquisition, including integration if the target firm is to be merged with the acquiring firm’s operations.

5. **Search criteria:** Develop criteria for identifying target firms and explain plans for conducting the search, why the target ultimately selected was chosen, and how you will make initial contact with the target firm.

6. **Negotiation strategy:** Identify key buyer/seller issues. Recommend a deal structure that addresses the primary needs of all parties involved. Comment on the characteristics of the deal structure. Such characteristics include the proposed acquisition vehicle (i.e., the legal structure used to acquire the target firm), the postclosing organization (i.e., the legal framework used to manage the combined businesses following closing), and form of payment (i.e., cash, stock, or some combination). Other characteristics include the form of acquisition (i.e., whether assets or stock are being acquired) and tax structure (i.e., whether it is a taxable or a nontaxable transaction). Indicate how you might “close the gap” between the seller’s price expectations and the offer price.

7. **Determine initial offer price:** Provide projected five-year income, balance sheet, and cash-flow statements for the acquiring and target firms (Continued)
EXHIBIT 7-4 (Continued)

individually, and for the consolidated acquirer and target firms with and without the effects of synergy. (Note that the projected forecast period can be longer than five years if deemed appropriate.) Develop a preliminary minimum and maximum purchase price range for the target. List key forecast assumptions. Identify an initial offer price, the composition (i.e., cash, stock, debt, or some combination) of the offer price, and why you believe this price is appropriate in terms of meeting the primary needs of both target and acquirer shareholders. The appropriateness of the offer price should reflect your preliminary thinking about the deal structure.

8. Financing plan: Determine if the proposed offer price can be financed without endangering the combined firm's creditworthiness or seriously eroding near-term profitability and cash flow. For publicly traded firms, pay particular attention to the near-term impact of the acquisition on the earnings per share of the combined firms.

9. Integration plan: Identify integration challenges and possible solutions. For financial buyers, identify an “exit strategy.”

A Case in Point: K2 Incorporated Acquires Fotoball USA

Our story begins in the early 2000s. K2 is a sporting goods equipment manufacturer whose portfolio of brands includes Rawlings, Worth, Shakespeare, Pflueger, Stearns, K2, Ride, Olin, Morrow, Tubbs, and Atlas. The company’s diversified mix of products is used primarily in team and individual sports activities, and its primary customers are sporting goods retailers, many of which are not strongly capitalized. Historically, the firm has been able to achieve profitable growth by introducing new products into fast-growing markets. Most K2 products are manufactured in China, which helps ensure cost competitiveness but also potentially subjects the company to a variety of global uncertainties.

K2’s success depends on its ability to keep abreast of changes in taste and style and to offer competitive prices. The company’s external analysis at the time

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8 This case is adapted from a paper written by Curt Charles, Tuukka Luolamo, Jeffrey Rathel, Ryan Komagome, and Julius Kumar, Loyola Marymount University, April 28, 2004. It is an attempt to reconstruct the preclosing events to illustrate how the acquisition process discussed in Chapters 4 and 5, as well as the specific process steps detailed in Chapter 6 and this chapter, may have been applied in this transaction. It suggests a highly condensed version of an actual business and acquisition plan.
showed that the most successful sporting goods suppliers would be those with the greatest resources, including management talent and capital; the ability to produce or source high-quality, low-cost products and deliver them on a timely basis; and access to distribution channels with a broad array of products and brands. Management expected that large retailers would prefer to rely on fewer and larger sporting goods suppliers to help them manage the supply of products and the allocation of shelf space.

The firm’s primary customers are sporting goods retailers. At the time, many of K2’s smaller retailers and some larger retailers were not strongly capitalized. Adverse conditions in the sporting goods retail industry could adversely impact the ability of retailers to purchase K2 products. Secondary customers included individuals, both hobbyists as well as professionals.

The firm had a few top competitors, but there were other large sporting goods suppliers with substantial brand recognition and financial resources with whom K2 did not compete. However, they could easily enter K2’s currently served markets. In the company’s secondary business, sports apparel, it did face stiff competition from some of these same suppliers, including Nike and Reebok.

K2’s internal analysis showed that the firm was susceptible to imitation, despite strong brand names, and that some potential competitors had substantially greater financial resources than K2. One key strength was the relationships K2 had built with collegiate and professional leagues and teams, not easily usurped. Larger competitors may have had the capacity to take away some of these relationships, but K2 had so many that it could withstand the loss of one or two. The primary weakness of K2 was its relatively small size in comparison to major competitors.

As a long-term strategic objective, K2 set out to be number one in market share in the markets it served by becoming the low-cost supplier. To that end, K2 wanted to meet or exceed its corporate cost of capital of 15 percent; achieve sustained double-digit revenue growth, gross profit margins above 35 percent, and net profit margins in excess of 5 percent within five years; and reduce its debt-to-equity ratio to the industry average of 25 percent in the same period. The business strategy for meeting this objective was to become the low-cost supplier in new niche segments of the sporting goods and recreational markets. The firm would use its existing administrative and logistical infrastructure to support entry into these new segments, new distribution channels, and new product launches through existing distribution channels. Also, K2 planned to continue its aggressive cost cutting and expand its global sourcing to include low-cost countries other than China.

All this required an implementation strategy. K2 decided to avoid product or market extension through partnering because of the potential for loss of control and for creating competitors once such agreements lapse. Rather, the strategy would build on the firm’s great success, in recent years, acquiring and
integrating smaller sporting goods companies with well-established brands and complementary distribution channels. To that end, M&A-related functional strategies were developed. A potential target for acquisition would be a company that holds many licenses with professional sports teams. Through its relationship with those teams, K2 could further promote its line of sporting gear and equipment.

In addition, K2 planned to increase its R&D budget by 10 percent annually over five years to focus on developing equipment and apparel that could be offered to the customer base of firms it acquired during the period. Existing licensing agreements between a target firm and its partners could be enhanced to include the many products K2 now offers. If feasible, the sales force of a target firm would be merged with that of K2 to realize significant cost savings.

K2 also thought through the issue of strategic controls. The company had incentive systems in place to motivate work toward implementing its business strategy. There were also monitoring systems to track the actual performance of the firm against the business plan.

In its acquisition plan, K2’s overarching financial objective was to earn at least its cost of capital. The plan’s primary nonfinancial objective was to acquire a firm with well-established brands and complementary distribution channels. More specifically, K2 sought an acquisition with a successful franchise in the marketing and manufacturing of souvenir and promotional products that could be easily integrated into K2’s current operations.

The acquisition plan included an evaluation of resources and capabilities. K2 established that after completion of a merger, the target’s sourcing and manufacturing capabilities must be integrated with those of K2, which would also retain management, key employees, customers, distributors, vendors and other business partners of both companies. An evaluation of financial risk showed that borrowing under K2’s existing $205 million revolving credit facility and under its $20 million term loan, as well as potential future financings, could substantially increase current leverage, which could—among other things—adversely affect the cost and availability of funds from commercial lenders and K2’s ability to expand its business, market its products, and make needed infrastructure investments. If new shares of K2 stock were issued to pay for the target firm, K2 determined that its earnings per share could be diluted unless anticipated synergies were realized in a timely fashion. Moreover, overpaying for any firm could result in K2 failing to earn its cost of capital.

Ultimately, management set some specific preferences: the target should be smaller than $100 million in market capitalization and should have positive cash flows, and it should be focused on the sports or outdoor activities market. The initial search, by K2’s experienced acquisition team, would involve analyzing current competitors. The acquisition would be made through a stock purchase—K2
chose to consider only friendly takeovers involving 100 percent of the target’s stock—and the form of payment would be new K2 nonvoting common stock. The target firm’s current year P/E should not exceed 20.

After an exhaustive search, K2 identified Fotoball USA as its most attractive target due to its size, predictable cash flows, complementary product offering, and many licenses with most of the major sports leagues and college teams. Fotoball USA represented a premier platform for expansion of K2’s marketing capabilities because of its expertise in the industry and place as an industry leader in many sports and entertainment souvenir and promotional product categories. K2 believed the fit with the Rawlings division would make both companies stronger in the marketplace. Fotoball also had proven expertise in licensing programs, which would assist K2 in developing additional revenue sources for its portfolio of brands. In 2003, Fotoball had lost $3.2 million, so it was anticipated that the company would be receptive to an acquisition proposal and that a stock-for-stock exchange offer would be very attractive to Fotoball shareholders because of the anticipated high-earning growth rate of the combined firms.

Negotiations ensued, and the stock-for-stock offer contained a significant premium, which was well received. Fotoball was a very young company at the time, and many of its investors were looking to make their profits through the growth of the stock. The offer would allow Fotoball shareholders to defer taxes until they decided to sell their stocks and be taxed at the capital gains rate. Earnouts were also included in the deal to give management incentives to run the company effectively and meet deadlines in a timely order.

Valuations for both K2 and Fotoball reflected anticipated synergies due to economies of scale and scope, namely, reductions in selling expenses of approximately $1 million per year, in distribution expenses of approximately $500,000 per year, and in annual G&A expenses of approximately $470,000. The combined market value of the two firms was estimated at $909 million—an increase of $82.7 million over the sum of the standalone values of the two firms.

Based on Fotoball’s outstanding common stock of 3.6 million shares, and the stock price of $4.02 at that time, a minimum offer price was determined by multiplying the stock price by the number of shares outstanding. The minimum offer price was $14.5 million. Were K2 to concede 100 percent of the value of synergy to Fotoball, the value of the firm would be $97.2 million. However, sharing more than 45 percent of synergy with Fotoball would have caused a serious dilution of earnings. To determine the amount of synergy to share with Fotoball’s shareholders, K2 looked at what portion of the combined firms’ revenues would be contributed by each of the players and then applied that proportion to the synergy. Because 96 percent of the projected combined firms’ revenues in fiscal year 2004 were expected to come from K2, only 4 percent of the synergy value was added to the minimum offer price to come up with an initial offer price of $17.8 million, or $4.94 per share. That represented a premium of 23 percent over the market value of Fotoball’s stock at the time.
The synergies and Fotoball’s relatively small size compared to K2 made it unlikely that the merger would endanger K2’s creditworthiness or near-term profitability. Although the contribution to earnings would be relatively small, the addition of Fotoball would help diversify and smooth K2’s revenue stream, which had been subject to seasonality in the past.

Organizationally, the integration of Fotoball into K2 would be achieved by operating Fotoball as a wholly owned subsidiary of K2, with current Fotoball management remaining in place. All key employees would receive retention bonuses as a condition of closing. Integration teams consisting of employees from both firms were set to move expeditiously according to a schedule established prior to closing the deal. The objective would be to implement the best practices of both firms.

On January 26, 2004, K2 Inc. completed the purchase of Fotoball USA in an all-stock transaction. Immediately after, senior K2 managers communicated (onsite, where possible) with Fotoball customers, suppliers, and employees to allay any immediate concerns.

**Things to Think About:**

1. How did K2’s acquisition plan objective support the realization of its corporate mission and strategic objectives?
2. What alternatives to M&As could K2 have employed to pursue its growth strategy? Why were the alternatives rejected?
3. How did the K2 negotiating strategy seek to meet the primary needs of the Fotoball shareholders and employees?
4. Do you believe K2 paid a fair price for Fotoball? Explain your answer.

Answers can be found at: www.elsevierdirect.com/companion.jsp?ISBN=9780123749482
CHAPTER 8

The Negotiation, Integration Planning, and Closing Phases

The negotiation phase often is the most complex aspect of the acquisition process. It involves refining the preliminary valuation, structuring the deal, conducting due diligence, and developing a financing plan. It is interactive and iterative. Activities unfold concurrently. It is during this phase that the actual purchase price paid for the acquired business is determined—and frequently the price will be quite a bit different from the initial valuation of the target company, which was probably made before due diligence and with only limited, publicly available information.

In this chapter, the emphasis is on negotiation in the context of problem solving or interest-based bargaining, in which parties look at their underlying interests rather than simply state positions and make demands. In most successful negotiations, parties to the transaction search jointly for solutions to problems. All parties must be willing to make concessions that satisfy their own needs as well as the highest-priority needs of the others involved in the negotiation.

You will learn here how to develop an effective negotiating strategy and how parties to a transaction can reach consensus on purchase price. You will also learn about the elements of integration planning and closing.

NEGOTIATION PHASE

The negotiation phase comprises four iterative activities that may begin at different times but tend to overlap. One activity is refining the preliminary valuation, which provides the starting point for negotiating the agreement of purchase and sale. This is based on new information uncovered as part of due diligence, another of the four activities, which provides additional information to enable the buyer to understand better the nature of the liabilities that may be assumed and to confirm perceived sources of value. (Due diligence, in fact, is also essential in postnegotiation phases.) Deal structuring involves meeting the needs of both parties by addressing issues of risk and reward by constructing an appropriate set of compensation, legal, tax, and accounting structures. The fourth of these activities is developing a financing
plan, which provides a reality check for the buyer by defining the maximum amount the buyer can reasonably expect to finance and, in turn, pay for the target company. Each of these activities is detailed in the following sections.

**Refining Valuation**

The starting point for negotiation is to update the preliminary target company valuation, based on new information. A buyer requests and reviews at least three to five years’ worth of historical financial data. Although it is highly desirable to examine data that have been audited in accordance with Generally Accepted Accounting Principles (GAAP), such data may not be available for small, privately owned companies. In fact, small companies rarely hire outside accounting firms to conduct expensive audits unless they are required to do so as part of a loan agreement.

The historical data should be normalized, or adjusted for nonrecurring gains, losses, or expenses. Nonrecurring gains or losses can result from the sale of land, equipment, product lines, patents, software, or copyrights. Nonrecurring expenses include severance payments, employee signing bonuses, and settlements of litigation. These adjustments allow the buyer to smooth out irregularities in the historical information and better understand the underlying dynamics of the business. After the data have been normalized, each major expense category should be expressed as a percentage of revenue. Through observance of year-to-year changes in these ratios, sustainable trends in the data are more discernable.

**Deal Structuring**

In purely financial terms, deal structuring involves the allocation of cashflow streams (with respect to amount and timing); the allocation of risk; and, therefore, the allocation of value between different parties to the transaction. However, because of the human element involved in negotiation, deal structuring must also be a process of identifying and satisfying as many of the highest-priority objectives of the parties involved in the transaction as possible, subject to their tolerance for risk. The process begins with each party determining its own initial negotiating position, potential risks, options for managing risk, levels of tolerance for risk, and conditions under which either party will “walk away” from the negotiations. (These elements of negotiation are discussed in considerably more detail at the end of this chapter, under “Thoughts on Negotiating Dynamics.”)

In practice, deal structuring is about understanding potential sources of disagreement—from simple arguments over basic facts to substantially more complex issues, such as the form of payment and legal, accounting,
and tax structures. It also requires understanding the potential conflicts of interest that can influence the outcome of discussions. For example, when a portion of the purchase price depends on the long-term performance of the acquired business, its management—often the former owner—may not behave in a manner that serves the acquirer’s best interests.

Decisions made throughout the deal-structuring process influence various attributes of the deal, including how ownership is determined, how assets are transferred, how ownership is protected (i.e., governance), and how risk is apportioned among parties to the transaction. Other attributes include the type, number, and complexity of the documents required for closing; the types of approvals required; and the time needed to complete the transaction. These decisions also will influence how the combined companies will be managed, the amount and timing of resources committed, and the magnitude and timing of current and future tax liabilities.¹

Deal structuring must also account for feedback effects, where one element of the process, such as the nature of payment (including amount, timing, and risk), may affect another element—in this example, tax strategies.

Given its complexity, the deal-structuring process should be viewed as comprising a number of interdependent components. At a minimum, these components include the acquisition vehicle, postclosing organization, legal form of the selling entity, form of payment, form of acquisition, and tax considerations. The acquisition vehicle refers to the legal structure (e.g., corporation or partnership) used to acquire the target company. The post-closing organization is the organizational and legal framework (e.g., corporation or partnership) used to manage the combined businesses following the completion of the transaction. The legal form of the selling entity refers to whether the seller is a C or subchapter S corporation, a limited liability company, or a partnership. These considerations will affect both the tax structure of the deal and form of payment. The form of payment may consist of cash, common stock, debt, or some combination. Some portion of the payment may be deferred or be dependent on the future performance of the acquired entity. The form of acquisition reflects both what is being acquired (e.g., stock or assets) and the form of payment. Consequently, the form of acquisition largely determines the tax structures. As a general rule, a transaction is taxable if remuneration paid to the target company’s shareholders is primarily something other than the acquirer’s stock, and it is nontaxable (i.e., tax deferred) if what they receive is largely acquirer stock. Finally, tax considerations refer to the potential impact of financial reporting

¹ McCarthy (1998); Tillinghast (1998).
requirements on the earnings volatility of business combinations, due to the need to periodically revalue acquired assets to their fair market value as new information becomes available. Fair market value is what a willing buyer and seller having access to the same information would pay for an asset.\(^2\)

**Conducting Due Diligence**

**Due diligence** is an exhaustive review of records and facilities and typically continues throughout the negotiation phase. Although some degree of protection is achieved through a well-written contract, legal documents should never be viewed as a substitute for conducting formal due diligence. Although due diligence is most often associated with buyers, both sellers and lenders will also conduct due diligence.\(^3\)

The acquirer typically attempts to protect itself through due diligence, extensive representations and warranties (i.e., claims and promises made by the seller), or some combination of the two. In some instances, buyers and sellers may agree to an abbreviated due diligence period on the theory that the buyer can be protected in a well-written agreement of purchase and sale in which the seller is required to make certain representations and warrant that they are true. These representations could include the seller’s acknowledgement that it owns all assets listed in the agreement “free and clear” of any liens, with a mechanism for compensating the buyer for any material loss (defined in the contract) should the representation be breached (i.e., found not to be true). Relying on reps and warranties as a substitute for a thorough due diligence effort is rarely a good idea.

An expensive and exhausting process, due diligence is, by its nature, highly intrusive and places considerable demands on managers’ time and attention. Frequently, the buyer wants as much time as necessary to complete due diligence, whereas the seller will want to limit the length and scope as much as possible.

Due diligence rarely works to the advantage of the seller because a long and detailed due diligence process is likely to uncover items the buyer will use as a reason to lower the purchase price. Consequently, sellers may seek to terminate due diligence before the buyer feels it is appropriate.\(^4\) If the

\(^2\) For a more detailed discussion of how to structure M&A transactions, see DePamphilis (2010).

\(^3\) For a detailed discussion of the due diligence process and best practices, see Selim (2003).

\(^4\) One way sellers try to limit due diligence is to sequester the acquirer’s team in a *data room.* Typically, this is a conference room filled with file cabinets and boxes of documents requested by the buyer’s due diligence team. Formal presentations by the seller’s key managers are given in the often-crammed conditions of the data room. In other instances, the potential buyer may have limited access to information on a password-protected website.
target firm succeeds in reducing the amount of information disclosed to the target firm, it can expect to be required to make more representations and warranties as to the accuracy of its claims and promises in the purchase and sale agreement. This will no doubt add to the negotiating time.5

The Components of Due Diligence
Three primary reviews comprise due diligence; they are of equal importance and often occur concurrently. The strategic and operational review conducted by senior operations and marketing management asks questions that focus on the seller’s management team, operations, and sales and marketing strategies. The financial review directed by financial and accounting personnel focuses on the accuracy, timeliness, and completeness of the seller’s financial statements. A legal review, conducted by the buyer’s legal counsel, deals with corporate records, financial matters, management and employee issues, tangible and intangible assets of the seller, and material contracts and obligations of the seller, such as litigation and claims. A rigorous due diligence process requires the creation of comprehensive checklists. The interview process provides invaluable sources of information. By asking the same questions of a number of key managers, the acquirer is able to validate the accuracy of its conclusions.

Buyer Due Diligence
Buyers use due diligence to validate assumptions underlying valuation. The primary objectives of buyer’s due diligence are to identify and confirm sources of value or synergy and mitigate real or potential liability by looking for fatal flaws that reduce value. Exhibit 8-1 categorizes potential sources of value from synergy that may be uncovered or confirmed during due diligence and the impact they may have on operating performance.

Seller Due Diligence
Although the bulk of due diligence is performed by the buyer on the seller, the prudent seller should also perform due diligence on the buyer. In doing so, the seller can determine whether the buyer has the financial wherewithal to finance the purchase. Frequently, as part of its own due diligence, a seller will require its managers to sign affidavits attesting (to the “best of their knowledge”) to the truthfulness of what is being represented in the contract that pertains to their areas of responsibility.

Prudent sellers also conduct internal due diligence. Through an investigation of its own operations, the seller hopes to mitigate liability stemming

5 A buyer is well advised to rely more on an onsite review of facilities and records and personnel interviews than on a seller’s contract obligations. Should a seller declare bankruptcy, disappear, or move assets to offshore accounts, receiving remuneration for breach of contract may be impossible.
<table>
<thead>
<tr>
<th>Potential Source of Value</th>
<th>Examples</th>
<th>Potential Impact</th>
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<tbody>
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<td>Operating Synergy:</td>
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<td></td>
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<tr>
<td>• Elimination of functional overlap</td>
<td>• Reduction in duplicate overhead positions (e.g., management)</td>
<td>• Improved margins</td>
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<tr>
<td>• Productivity improvement</td>
<td>• Increased output per employee</td>
<td>• Same</td>
</tr>
<tr>
<td>• Purchasing discounts</td>
<td>• Volume discounts on material purchases</td>
<td>• Same</td>
</tr>
<tr>
<td>• Working capital management</td>
<td>• Reduced days in receivables due to improved collection of accounts receivable</td>
<td>• Improved return on total assets</td>
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<tr>
<td></td>
<td>• Fewer days in inventory due to improved inventory turns</td>
<td>• Same</td>
</tr>
<tr>
<td>• Facilities management</td>
<td></td>
<td></td>
</tr>
<tr>
<td>– Economies of scale</td>
<td>• Increased production in underutilized facilities</td>
<td>• Same</td>
</tr>
<tr>
<td>– Economies of scope</td>
<td>• Data centers, R&amp;D functions, call centers, etc., support multiple product lines/operations</td>
<td>• Same</td>
</tr>
<tr>
<td>• Organizational realignment</td>
<td>• Reduction in the number of layers of management</td>
<td>• Improved communication</td>
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<td></td>
<td></td>
<td>• Reduced bureaucratic inertia</td>
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<tr>
<td>Financial Synergy:</td>
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<td></td>
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<tr>
<td>• Increased borrowing capacity</td>
<td>• Target has little debt and many unencumbered assets</td>
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<td>• Increased leverage</td>
<td>• Access to lower-cost source of funds</td>
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<td>Marketing/Product Synergy:</td>
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<tr>
<td>• Access to new distribution channels</td>
<td>• Increased sales opportunities</td>
<td>• Increased revenue</td>
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<tr>
<td>• Cross-selling opportunities</td>
<td>• Selling acquirer products to target customers and vice versa</td>
<td>• Same</td>
</tr>
<tr>
<td>• Research &amp; development</td>
<td>• Cross-fertilization of ideas</td>
<td>• More innovation</td>
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<tr>
<td>• Product development</td>
<td>• Increased advertising budget</td>
<td>• Improved market share</td>
</tr>
<tr>
<td>Control:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>• Opportunity identification</td>
<td>• Acquirer sees opportunities not seen by target’s management</td>
<td>• New growth opportunities</td>
</tr>
<tr>
<td>• More proactive management style</td>
<td>• More decisive decision making</td>
<td>• Improved financial returns</td>
</tr>
</tbody>
</table>
from inaccuracies in the seller’s representations and warranties made in the definitive agreement of purchase and sale.

**Lender Due Diligence**
If the acquirer is borrowing to buy a target firm, the lender(s) will want to perform their own due diligence independent of the buyer’s effort. Multiple lender due diligences, often performed concurrently, can be quite burdensome to the target firm’s management and employees, and the seller should agree to these disruptive activities only if confident that the transaction will be consummated within a reasonable period.

**Developing the Financing Plan**
The last of the four negotiation phase activities is to develop balance sheet, income, and cash-flow statements for the combined firms. Unlike the financial projections of cash flow made to value the target, these statements should include the expected cost of financing the transaction. Developing the financing plan is a key input in determining the purchase price because it places a limitation on the amount the buyer can offer the seller. It largely is used as a marketing or sales document to negotiate the best possible terms for financing the proposed transaction. (The financing plan and way transactions are financed are discussed in more detail in Chapter 9.)

The financing plan is appended to the acquirer’s business and acquisition plans and is used to obtain financing for the transaction. No matter the size of the transaction, lenders and investors will want to see a coherent analysis of why the proposed transaction is a good investment opportunity.

Most well-written agreements of purchase and sale contain a financing contingency. The buyer is not subject to the terms of the contract if the buyer cannot obtain adequate funding to complete the transaction. Breakup fees (see Chapter 3) can be particularly useful to ensure that the buyer will attempt to obtain financing as aggressively as possible. In some instances, the seller may require the buyer to put a nonrefundable deposit in escrow to be forfeited if the buyer is unable to obtain financing to complete the transaction. (Escrow is discussed further at the end of this chapter.)

**INTEGRATION PLANNING PHASE**
The euphoria that surrounds the successful completion of a transaction erodes quickly when the challenges of making the combined firms perform in line with the predictions laid out in the business and acquisition
plans become apparent. After the documents are signed, the buyer has lost most, if not all, leverage over the seller.

Part of the premerger integration planning process involves the preclosing due diligence activity. One responsibility of the due diligence team is to identify ways in which assets, processes, and other resources can be combined to realize cost savings, productivity improvements, or other perceived synergies. This information is also essential for refining the valuation process by enabling planners to understand better the necessary sequencing of events and the resulting pace at which the expected synergies may be realized. Consequently, understanding how and over what period the integration will be implemented is important in determining the magnitude and timing of the cash flows of the combined companies used to make the final assessment of value.

Integration planning also involves addressing human resource, customer, and supplier issues that overlap the change of ownership. These are transitional issues to resolve as part of the agreement of purchase and sale, and it is critical that the seller’s responsibilities be negotiated before closing to make the actual transition as smooth as possible. Also, a cooperative effort is most likely prior to closing. For example, the agreement may stipulate how target company employees will be paid and how their benefit claims will be processed. Similar timing issues exist for target company customers and suppliers. For example, the merger agreement should specify how the seller should be reimbursed for products shipped or services provided by the seller before closing, but not paid for by the customer until after closing.

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6 Systems must be in place to ensure that employees of the acquired company continue to be paid without disruption. If the number of employees is small, this task may be accommodated easily by loading the acquirer’s payroll computer system with the necessary salary and personnel information before closing, or by having a third-party payroll processor perform these services. For larger operations or where employees are dispersed geographically, the target’s employees may continue to be paid for a specific period using the target’s existing payroll system. As for benefits, employee health care or disability claims tend to escalate just before a transaction closes, and studies show that employees, whether they leave or stay with the new firm, file more disability claims for longer periods after downsizing (The Wall Street Journal, November 21, 1996). The sharp increase in such expenses can pose an unexpected financial burden for the acquirer if the responsibility for paying such claims has not been addressed in the merger agreement. For example, the agreement may read that all claims incurred within a specific number of days before closing, but not submitted by employees for processing until after closing, will be reimbursed by the seller after the closing. Alternatively, such claims may be paid from an escrow account containing a portion of the purchase price set aside to cover these types of expenses.

7 A prudent buyer typically would be the recipient of such payments because the seller’s previous lockboxes (i.e., checking accounts) would have been closed and replaced by those of the buyer. Likewise, the buyer will want to be reimbursed by the seller for monies owed to suppliers for products or services provided to the seller before closing, but not billed until after closing. The merger agreement may indicate that both parties will keep track of customer and supplier invoices paid during the 60 to 90 days following closing and will submit them for reimbursement to the other party at the end of that period.
A prudent buyer will want to include certain assurances in the agreement of purchase and sale to limit its postclosing risk. Most seller representations and warranties made to the buyer refer to the past and present condition of the seller’s business. They pertain to items such as the ownership of securities; real and intellectual property; current levels of receivables, inventory, and debt; pending lawsuits, worker disability, and customer warranty claims; and an assurance that the target’s accounting practices are in accordance with Generally Accepted Accounting Principles. Although “reps and warranties” apply primarily to the past and current state of the seller’s business, they do have ramifications for the future. For example, if a seller claims that there are no lawsuits pending and a lawsuit is filed shortly after closing, the buyer may seek to recover damages from the seller.

The buyer also may insist that certain conditions be satisfied before closing can take place. Common conditions include employment contracts, agreements not to compete, financing, and regulatory and shareholder approval. The buyer usually will insist that key target company employees sign contracts obligating them to remain with the newly formed company for a specific period. The former owners, managers, and other key employees also are asked to sign agreements precluding them from going into any business that would directly compete with the new company during the duration of the noncompete agreement. Finally, the buyer will want to make the final closing contingent on receiving approval from the appropriate regulatory agencies and shareholders of both companies before any money changes hands.

**Earning Trust**

Decisions made before closing affect postclosing integration activity. Benefits packages, employment contracts, and retention bonuses to keep key employees typically are negotiated before closing. Contractual covenants and conditions also affect integration. **Earnouts**, which are payments to the seller based on the acquired business achieving certain profit or revenue targets, and deferred purchase price payments, involving the placement of some portion of the purchase price in escrow until certain contractual conditions have been realized, can limit the buyer’s ability to integrate the target effectively into the acquirer’s operations. Successfully integrating firms requires getting employees in both firms to work toward achieving common objectives. This comes about through building credibility and trust, not through superficial slogans, pep talks, and empty promises. Trust comes from cooperation and experiencing success.
**Earnouts**

An earnout is usually a very poor way to create trust and often represents a major impediment to the integration process. The two firms generally are kept physically separate. Accounting and management reporting systems are not merged immediately, data centers remain separate, and sales forces remain largely independent. The buyer’s concern is that the effort to integrate the firms as soon as possible after closing will make tracking the financial progress of the acquired company toward meeting its earnout goals difficult. Moreover, the merging of facilities and sales forces could create a highly contentious situation after the earnout period has elapsed if the acquired company did not meet the earnout goals. Employees covered by the earnout could argue in court that they were prevented from meeting earnout goals because the buyer did not allow them to implement the business plan on which the earnout was based.

**Choosing the Integration Manager and Other Critical Decisions**

The buyer should designate an integration manager who possesses excellent interpersonal and project management skills. During the integration phase, interpersonal skills are frequently more important than professional and technical skills. The buyer must also determine what is critical to continuing the acquired company’s success during the first 12 to 24 months following closing. Critical activities include identifying key managers, vendors, and customers, and what is needed to retain them as valued assets. Preclosing integration planning activities should also determine operating norms or standards required for continued operation of the businesses: executive compensation, labor contracts, billing procedures, product delivery times, and quality metrics. Finally, there must be a communication plan for all stakeholders that can be implemented immediately following closing.\(^8\) Chapter 10 describes in detail how the integration plan is implemented.

**CLOSING PHASE**

In the **closing** phase of the acquisition process, you obtain all necessary shareholder, regulatory, and third-party consents (e.g., customer and vendor contracts) and also complete the definitive agreement of purchase and sale. Like all other phases, this activity benefits from significant planning at

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the outset if it is to go smoothly. Unfortunately, this is frequently impractical because so many activities are underway during the acquisition process, and they tend to converge on the closing date.

**Assigning Customer and Vendor Contracts**

In a purchase of assets, many customer and vendor contracts cannot be assigned to the buyer without receiving written approval from the other parties. Although this may be largely a formality, both vendors and customers may view it as an opportunity to attempt to negotiate more favorable terms. Licenses must be approved by the licensor, which can be a major impediment to a timely closing if not properly planned. For example, a major software vendor demanded a substantial increase in royalty payments before agreeing to transfer the software license to the buyer. The vendor knew that the software was critical for the ongoing operation of the target company’s data center. From the buyer’s perspective, the exorbitant increase in the fee had an adverse impact on the economics of the transaction and nearly caused the deal to collapse.

There are also the *transitional* issues, introduced earlier, that must be addressed before closing, including continued payroll processing support by the seller, on behalf of the buyer, until the buyer is able to assume this function, and the return of checks received by the seller from customers continuing to send checks to the seller’s bank accounts after closing. Similarly, the buyer will want to be reimbursed by the seller for payments made by the buyer to vendors for materials supplied or services provided before closing, but not paid until after closing.

**Gaining the Necessary Approvals**

The buyer’s legal counsel is responsible for ensuring that the transaction is in full compliance with securities, antitrust, and state corporation laws. Significant planning before closing is again crucial to minimizing roadblocks that a target company may place before the buyer. Great care must be exercised to ensure that all filings required by law have been made with the Federal Trade Commission and the Department of Justice. Noncompliance can delay or prevent a merger or acquisition. Finally, many transactions require approval by the acquirer and target company shareholders.

**Completing the Acquisition/Merger Agreement**

The acquisition/merger agreement is the cornerstone of the closing documents. It indicates all of the rights and obligations of the parties both
before and after closing. This agreement also may be referred to as the definitive agreement of purchase and sale; its length depends on the complexity of the transaction.

**Deal Provisions**

In an asset or stock purchase, the deal provisions section of the agreement defines the consideration or form of payment and how it will be paid, and the specific assets or shares to be acquired. In a merger, this section of the agreement defines the number (or fraction) of acquirer shares to be exchanged for each target share.

**Price**

The purchase price or total consideration may be fixed at the time of closing, subject to future adjustment, or it may be contingent on future performance. The purchase price may be fixed initially based on the seller’s representations of the firm’s total assets, total book value, tangible book value, or some other measure of value. However, the price may be adjusted following a postclosing audit. In asset transactions, it is common to exclude cash on the target’s balance sheet from the transaction; the price paid for noncurrent assets, such as plant and intangible assets will be fixed, but the price for current assets will depend on their levels at closing.

**Allocation of Price**

The buyer typically has an incentive to allocate as much of the purchase price as possible to depreciable assets, such as fixed assets, customer lists, and noncompete agreements, which will enable the buyer to depreciate or amortize these upwardly revised assets and reduce future taxable income. However, such an allocation may constitute taxable income to the seller. Both parties should agree on how the purchase price should be allocated to the various assets acquired in an asset transaction before closing. This agreement eliminates the chance that the parties involved will take different positions for tax purposes. Nonetheless, the IRS may still challenge the transaction.

**Payment Mechanism**

Payment may be made at closing by wire transfer or cashier’s check. The buyer may defer the payment of a portion of the purchase price by issuing a promissory note to the seller. The buyer may agree to put the unpaid portion of the purchase price in escrow or through a holdback allowance,
thereby facilitating the settlement of claims that might be made in the future. The escrow account involves the buyer putting a portion of the purchase price in an account held by a third party, whereas the holdback allowance generally does not.

**Assumption of Liabilities**

The seller retains those liabilities not assumed by the buyer. In instances such as environmental liabilities, unpaid taxes, and inadequately funded pension obligations, the courts may go after the buyer and seller. In contrast, the buyer assumes all known and unknown liabilities in a merger or purchase of shares.

**Representations and Warranties**

The reps and warranties should provide for full disclosure of all information germane to the transaction, typically covering the areas of greatest concern to both parties. Areas commonly covered include the following: corporate organization and good standing, capitalization, financial statements, absence of undisclosed liabilities, current litigation, contracts, title to assets, taxes and tax returns, no violation of laws or regulations, employee benefit plans, labor issues, and insurance coverage.

**Covenants**

*Covenants* are agreements by the parties about actions they agree to take, or refrain from taking, between signing the definitive agreement and the closing. For example, the seller may be required to continue conducting business in the usual and customary manner. The seller often will be required to seek approval for all expenditures that may be considered out of the ordinary, such as one-time dividend payments or sizeable increases in management compensation.

**Closing Conditions**

The satisfaction of negotiated conditions determines whether a party to the agreement must go forward and consummate the deal. These conditions could include the continued accuracy of the seller’s reps and warranties and the extent to which the seller is living up to its obligations under the covenants. Other examples include obtaining all necessary legal opinions, the execution of other agreements (e.g., promissory notes), and the absence of any “material adverse change” in the condition of the target company.
The effects of material adverse change clauses (MACs) in agreements of purchase and sale became very visible during the disruption in the financial markets in 2008. Many firms that had signed M&A contracts looked for a way out. The most common challenge in negotiating such clauses is defining what constitutes materiality; for example, is it a 20 percent reduction in earnings or sales? Because of the inherent ambiguity, the contract language is usually vague, and it is this very ambiguity that has enabled so many acquirers to withdraw from contracts. Lenders, too, use these clauses to withdraw financing (see the “Financing Contingencies” section).

**Indemnification**

In effect, *indemnification* is the reimbursement of the other party for a loss incurred following closing for which it was not responsible. The definitive agreement requires the seller to indemnify or absolve the buyer of liability in the event of misrepresentations or breaches of warranties or covenants. Similarly, the buyer usually agrees to indemnify the seller. Both parties generally want to limit the period during which the indemnity clauses remain in force. At least one full year of operation and a full audit are necessary to identify claims. Some claims (e.g., environmental) extend beyond the survival period of the indemnity clause. Usually, neither party can submit claims to the other until some minimum threshold, expressed in terms of the number or dollar size of claims, has been exceeded.

**Merger Agreements**

A merger is structurally simpler than an asset agreement because it does not require the stipulation of assets being transferred to the buyer and liabilities assumed by the buyer. Although it may take less time to negotiate and draft than an asset agreement, it may take longer to complete. A merger with a public company generally requires approval of the target company’s shareholders and must comply with the full public disclosure and filing requirements of both federal and state securities laws.

**Other Closing Documents**

In addition to resolving the issues outlined previously, closing may be complicated by the number and complexity of other documents required to complete the transaction. In addition to the agreement of purchase and sale, the more important documents often include patents, licenses, royalty agreements, trade names, and trademarks; labor and employment agreements; leases; mortgages, loan agreements, and lines of credit; stock and
bond commitments and details; supplier and customer contracts; distributor and sales representative agreements; stock option and employee incentive programs; health and other benefit plans (which must be in place at closing to eliminate lapsed coverage); complete description of all foreign patents, facilities, and investments; insurance policies, coverage, and claims pending; intermediary fee arrangements; litigation pending for and against each party; environmental compliance issues resolved or on track to be resolved; seller’s corporate minutes of the board of directors and any other significant committee information; and articles of incorporation, bylaws, stock certificates, and corporate seals.9

**Financing Contingencies**

Most well-written agreements of purchase and sale contain a financing contingency. The buyer is not subject to the terms of the contract if the buyer cannot obtain adequate funding to complete the transaction. As previously discussed, breakup fees can be particularly useful to ensure that the buyer will attempt as aggressively as possible to obtain financing. In some instances, the seller may require the buyer to put a nonrefundable deposit in escrow to be forfeited if the buyer is unable to obtain financing to complete the transaction.

Lenders, too, exercise financial contingencies, invoking material adverse change clauses to back out of lending commitments. For example, concerned that they will have to discount such loans when they are resold, Morgan Stanley and UBS balked at commitments to fund the purchase of Reddy Ice Holdings and Genesco in late 2007. Similarly, Lehman and J.P. Morgan were part of a group of banks that helped force Home Depot to take $1.8 billion less for its construction supply business.10

**Is Closing Ever Simple?**

The closing experience runs the gamut from mind-numbing routine to bombastic confrontation. The smoothness of the process depends on its overall complexity and the level of trust between the parties involved.

Transaction size is not a good indicator of complexity. Transactions that are relatively small in terms of revenue or purchase price can be horrifically complicated where multiple parties are involved, significant

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9 Sherman (2006).
10 Although only the 10th-largest transaction of 2007 in terms of price, the Home Depot deal became one of the most important by midyear as among the first of the large, highly leveraged transactions to be renegotiated following the collapse of the subprime mortgage market in late summer.
off-balance sheet liabilities exist, or multiple levels of regulatory approval are required. Even when it appears that both parties have reached agreement on the major issues, what were previously minor issues seem to resurface on a more challenging scale. Sometimes this happens because the parties did not realize an issue’s significance until the last minute. Other times, one party takes a hard line on an issue as the closing date approaches, hoping to gain a negotiating advantage. In one instance, a buyer of a computer maintenance business sat in the seller’s mahogany-filled boardroom just minutes before the closing documents were to be signed and began to enumerate concerns he had with the deal. As tempers began to flare, only the seller’s threat to walk away from the transaction compelled the buyer to relent and close the transaction. Such tactics are ill-advised.

Money issues tend to be among the more challenging to resolve. Postclosing balance sheet adjustments and escrow accounts, earnouts and other contingent payments, contingent value rights, staging investment, rights to intellectual property, licensing fees, and consulting agreements commonly are used to consummate the deal when buyers and sellers are finding it difficult to reach agreement on purchase price. These issues are discussed in more detail later, under “Thoughts on Closing the Price Gap.”

Although closing normally involves one central location, offsite locations may be needed if documents for transferring deeds and titles to assets must be signed and filed from remote locations. These locations substitute for face-to-face signings that may be difficult because of distance or cost. Remote signings may be completed by having power of attorney for the buyer and seller transferred to local attorneys at each remote site. It is also a good idea to have separate conference rooms for the buyer and seller to ensure privacy, and another room in which the parties meet to execute the documents. Finally, lenders should be kept separate from each other to minimize any exchange of information during closing that might cause them to reopen discussions between the buyer and the lender about the terms and conditions of loans.

For small, uncomplicated transactions, faxes may suffice at first, with documents sent back and forth between the buyer and seller to ensure that there is complete agreement on the closing documents. Signature pages are then signed by one party and sent overnight to the other party for signature.

THOUGHTS ON NEGOTIATING DYNAMICS

Negotiating is essentially a process in which two or more parties, representing different interests, attempt to achieve a consensus on a particular
issue. It is useful to start a negotiation by determining any areas of disagreement, which can be done by having all parties review the facts pertaining to the deal at the beginning. Generally, parties reach agreement on most facts relatively easily. From there, it is easy to identify areas in dispute. Good negotiators make concessions on issues not considered deal breakers—anything to which a party cannot agree without making the deal unacceptable—but only if they receive something in return. If there are deal breakers, they must be the highest priority in a negotiation. Deal breakers must be resolved if a negotiated settlement is to be reached.

The easiest areas of disagreement should be resolved first. By the time only a few remain, all parties to the negotiation have invested a great deal of money, time, and emotional commitment to the process and will be looking forward to resolving any remaining issues quickly.

In a negotiation, all positions should be explained logically. Unreasonable demands at any point in the negotiation are likely to evoke frustration and encourage someone to end discussions. If the parties can reach a point at which one side is at least willing to state a price range, final agreement is in sight.

Sound planning is the key to successful negotiation. Prior to negotiating, each party should determine its own goals (i.e., highest-priority needs) and prioritize those goals. Is money the major issue, or is it more about gaining control? Each party should also make an effort to identify the other party’s goals and priorities based on public statements and actions, as well as information uncovered during due diligence. With clearly identified goals, each party can develop strategies for achieving those goals. Each party needs to recognize that allowances must be made so other parties can achieve—or at least believe they have achieved—their primary goals.

All moves in a negotiation should be supported by the most objective rationale possible; a well-reasoned and well-structured proposal is difficult to counter. The first move of any negotiation can set the tone for the entire process. A reasonable offer is more likely to appeal to the other side and more likely to elicit a reasonable counteroffer. Skilled negotiators often employ a series of techniques to reach consensus. For example, negotiators may try to determine the minimum outcome the other party will accept and then adjust their demands accordingly, without giving up their highest-priority objectives.

Traditional negotiating has been referred to as the “win–lose” approach, based on the assumption that one’s gain is necessarily another’s loss. This is true when only one issue is at stake. For example, if a seller accepts a lower
cash purchase price, and if cash is a high-priority concern to the buyer and the seller, the buyer gains at the seller’s expense. “Win–win” negotiations, in contrast, presume there are outcomes in which both parties to a negotiation gain; these negotiations involve multiple related issues. In a win–win negotiation, one party can concede what it believes to be a relatively low-priority item in exchange for the other party’s acceptance of something else that it believes highly important.

When it comes to issues of money, it can be important to reach agreement first on a formula or framework for determining what both parties believe is a fair value. Reaching such an agreement may require intense discussion. A formula might be that the purchase price will be some multiple of earnings or cash flow; a framework might comprise a series of steps, such as the extent of due diligence to be allowed, before a purchase price is proposed. The formula or framework can help avoid the thorny issue of how much to offer at the outset, and enables negotiators to proceed to the data collection or due diligence stage.¹¹

THOUGHTS ON CLOSING THE PRICE GAP

Again, the seller may insist the buyer state a price range before allowing the buyer to perform due diligence and before entering into negotiations. Due diligence may uncover issues that cause the prospective buyer to reduce the offer price, which the seller is likely to resist. To reach a settlement, both parties must think creatively.

In an all-cash transaction, the risks accrue entirely to the buyer. Despite exhaustive due diligence, there is no assurance that the buyer will have uncovered all the risks associated with the target. During the negotiation phase, the buyer and seller maneuver to share the perceived risk and apportion the potential returns. In doing so, substantial differences arise between what the buyer is willing to pay and what the seller believes the business is worth.

Buyers and sellers use postclosing balance sheet adjustments and escrow accounts, earnouts, contingent payments, contingent value rights, staging investment, rights to intellectual property, licensing fees, consulting agreements, and seller financing when they cannot reach agreement on purchase price. Postclosing price adjustment mechanisms include escrow or holdback accounts and adjustments to the target’s balance sheet. These mechanisms rely on a postclosing audit of the target firm to determine its

¹¹ DePamphilis (2010).
“true” value. Generally, the buyer and seller share the cost of the audit. In general, such mechanisms are applicable only when what is being acquired is clearly identifiable, such as in a purchase of tangible assets. Moreover, these mechanisms most often are used in cash-for-stock purchases, rather than stock-for-stock purchases, particularly when the number of target shareholders is large. Attempting to recover a portion of the shares paid to target shareholders may trigger litigation. Also, retaining a portion of the shares paid to target shareholders may communicate suspected problems with the target and trigger a sale by target shareholders of the shares. Google’s share-for-share purchase of YouTube involved a holdback of a portion of the purchase price because of the potential for copyright infringement litigation.

With escrow accounts, the buyer retains a portion of the purchase price until completion of a postclosing audit. Balance sheet adjustments most often are used in purchases of assets when there is a lengthy time between the agreement on price and the actual closing date, often resulting from the need to obtain regulatory or shareholder approvals to complete the transaction. During this period, balance sheet items—particularly those related to working capital—may change significantly. For example, if the book value of the acquired net assets (i.e., the difference between acquired assets and assumed liabilities) decreases between the signing of an agreement and the actual closing, the buyer will be entitled to a price reduction equal to the decline in acquired net assets. The magnitude of the decline is determined during the postclosing audit.

Earnouts and warrants frequently are used whenever the buyer and seller cannot agree on the probable performance of the seller’s business over some period into the future, or when the parties involved wish to participate in the upside potential of the business. Earnouts may also be used to retain and motivate key target firm managers. An earnout is a financial contract whereby a portion of the purchase price of a company is to be paid in the future, contingent on the realization of a previously agreed-upon future earnings level or some other performance measure. The terms of the earnout are stipulated in the agreement of purchase and sale.

Subscription warrants, more commonly known as warrants, are a type of security often issued with a bond or preferred stock. They are another mechanism that shifts some of the risk associated with the target’s future performance to the target firm’s shareholders. By accepting warrants as a form of payment, target shareholders are able to share in any future appreciation of the value of the business. A warrant entitles the holder to purchase an amount of common stock at a stipulated exercise price, usually higher
than the price at the time the warrant is issued. Warrants may be converted over a period of many months to many years. In contrast, a rights offering to buy common shares normally has an exercise price below the current market value of the stock and a life of four to eight weeks.

In M&A transactions, **contingent value rights (CVRs)** are commitments by the issuing company (i.e., the acquirer) to pay additional cash or securities to the holder of a CVR (i.e., the seller) if the share price of the issuing company falls below a specified level at some future date. CVRs provide a guarantee of future value as of a point in time for one of various forms of payment made to the seller, such as cash, stock, or debt. Although relatively rare, such rights are sometimes granted in deals in which there are large differences between the buyer and seller with respect to the purchase price. Such rights may also be used when the target firm wants protection for any remaining minority shareholders fearful of being treated unfairly by the buyer.

Tembec Inc.’s 1999 acquisition of Crestbrook Forest Products, Ltd., illustrates how CVRs work. Each Crestbrook shareholder received a CVR that enabled the shareholder to receive a one-time payment on March 31, 2000, of up to a maximum of $1.50 per share. The size of the payout depended on the amount by which the average price of wood pulp for 1999 exceeded $549.00/ton. Similarly, in a 1995 transaction, MacAndrews & Forbes provided each shareholder of Abex Inc. a CVR per common share equal to $10.00 to ensure that Abex shareholders would receive at least that amount per share. In 2008, French utility EDF was able to overcome resistance from certain British Energy shareholders by offering a combination of cash and a CVR that enabled investors to share in future profits whenever electrical output and energy prices rise, with the amount of future payouts dependent on the amount of the increase in profits.

**Distributed payments** or **staged payouts** involve purchase price payments contingent on the target satisfying an agreed-upon milestone. Such milestones could include achieving a profit or cash-flow target, successfully launching a new product, obtaining regulatory or patent approval, and so on. Distributing the payout over time allows the acquirer to manage the risk by reducing some of the uncertainty about future cash flows. An acquirer could also avoid having to finance the entire cash purchase price in a large transaction at one time. In 2008, the Swiss pharmaceutical firm Novartis acquired Nestle’s controlling interest in eye care company Alcon for $39 billion, but—given the 2008 credit crisis—deferred financing the bulk of the transaction for several years.

Rights to intellectual property, royalties from licenses, and fee-based consulting or employment agreements are other forms of payment that
can be used to close the gap between what the buyer is willing to offer and what the seller expects. Having the right to use a proprietary process or technology free or at a rate below the prevailing market may be of interest to the former owners as they pursue other business opportunities. Obviously, such arrangements should be coupled with reasonable agreements not to compete in the same industry as their former firm. Contracts may be extended to both the former owners and their family members. By spreading the payment of consulting fees or salary over a number of years, the seller may be able to reduce the income-tax liability that might have resulted from receiving a larger lump-sum purchase price.

**Seller financing** is a loan provided by the seller of a property to the buyer to cover all or part of the sale price. Also known as owner carry back or owner financing, this process is used in a variety of situations. For small deals in which a large percentage of purchase price is cash, seller financing may be used to cover the balance of the purchase price. In extending such financing, the seller is expressing a willingness to shoulder a portion of the risk associated with the deal.

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The key to successful negotiation, integration, and closing is sound planning. Developing an integration plan with the cooperation of the seller is a critical factor contributing to a successful integration of the acquirer and target businesses following closing. All activities converge on the closing date on which ownership transfers from the seller to the buyer—and it can be a time of high stress.

Chapter 9 details the financing of transactions, and Chapter 10 discusses the final phase of M&A: postclosing integration.

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**A Case in Point: InBev Buys an American Icon for $52 Billion**

For many Americans, Budweiser is synonymous with American beer, and American beer is synonymous with beer giant Anheuser-Busch (AB). Ownership of this American icon changed hands on July 14, 2008, when Anheuser-Busch agreed to be acquired by Belgian brewer InBev for $52 billion in an all-cash deal. The combined firms would have annual revenue of about $36 billion and control about 40 percent of the U.S. beer market and 25 percent of the global market.

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12 Note that such an arrangement, if priced at below-market rates or if free to the seller, would constitute taxable income to the seller.
InBev’s purchase is part of a wave of consolidation in the global beer industry, which reflects an attempt to offset rising commodity costs by achieving greater scale and purchasing power. Although the transaction is likely to generate cost savings of about $1.5 billion annually by 2011, InBev stated publicly that it is about the two firms being complementary rather than overlapping.

The announcement marked a reversal from AB’s publicly stated position only a week earlier that InBev’s offer undervalued the firm. Subsequently, AB sued InBev for “misleading statements” it had allegedly made about the strength of its financing. To court public support, AB publicized its history as a major benefactor in its hometown area of St. Louis, Missouri. The firm argued that its own long-term business plan would create more shareholder value than the proposed deal. To make the transaction too expensive for InBev, AB contemplated acquiring the half of Grupo Modelo, the Mexican brewer of Corona, it did not already own. Meanwhile, AB was under substantial pressure from major investors, including Warren Buffet, to agree to the deal because the firm’s stock had been lackluster for the past several years.

While publicly professing to want a friendly transaction, InBev wasted no time turning up the heat. The firm launched a campaign to replace AB’s board with its own slate of candidates, including a Busch family member. In an effort to win additional shareholder support, InBev raised its initial $65 bid to $70. To eliminate concerns over its ability to finance the deal, InBev agreed to document its credit sources fully, rather than rely on more traditional but less certain credit commitment letters. In an effort to placate AB’s board, management, and the myriad politicians who railed against the proposed transaction, InBev agreed to name the new firm Anheuser-Busch InBev, keep Budweiser as the new firm’s flagship brand, and maintain North American headquarters in St. Louis. In addition, AB would be given two seats on the board, including one for August A. Busch IV, AB’s CEO and patriarch of the firm’s founding family. InBev also announced that AB’s 12 U.S. breweries would remain open.

Things to Think About:
1. Explain InBev’s motives for acquiring Anheuser-Busch. Be specific.
2. What unusual hurdles did InBev have to overcome in acquiring Anheuser-Busch? Be specific.
4. What developments in 2009 suggest that InBev may have overpaid significantly for Anheuser Busch?
5. How might certain concessions made by InBev to close the deal make it difficult for the firm to reach its desired financial returns? Be specific.

Answers can be found at: www.elsevierdirect.com/companion.jsp?ISBN=9780123749482
CHAPTER 9

Financing Transactions

A merger and acquisition financing plan comprising balance sheet, income, and cash-flow statements for the combined firms should be developed before negotiations have been completed. Unlike the financial statements used to value the target firm, financial statements here should include the expected cost of financing the transaction—critical input because it places a limit on how much of the proposed purchase price the buyer can offer the seller. The financial plan also provides insights into the appropriate composition of the purchase price by projecting the potential for earnings per share (EPS) dilution if the acquirer issues a substantial number of new shares, as well as the potential for higher borrowing costs if leverage is increased significantly. Consequently, by simulating alternative financial structures (e.g., debt-to-equity ratios), the acquirer can gain insight into what might constitute the least costly way of financing the transaction. The financing plan may be said, therefore, to constitute a reality check for the buyer.

This chapter discusses how transactions are financed and addresses the complex capital structures of highly leveraged transactions, such as leveraged buyouts and ways of selecting the appropriate capital structure.

FINANCING OPTIONS: BORROWING

Once a prospective target has been identified, the buyer may choose from a number of financing alternatives. For the risk-averse acquirer, the ideal mechanism may be to finance the transaction with cash held by the target in excess of normal working capital requirements—but such situations are rare. Venture capital or so-called angel investors also may be available to fund the transaction. However, this option may represent very expensive financing because the buyer may have to give up majority ownership of the acquired company. Use of the buyer’s stock may be an appropriate way to minimize the initial cash outlay, but that option is rarely available in a management buyout or a buyout by privately held companies.

The seller may be willing to accept debt issued by the buyer if an upfront cash payment is not important. Doing so may be highly disadvantageous to the buyer if the seller places substantial restrictions on how the business may
be managed. The use of a public issue of long-term debt to finance the transaction may minimize the initial cash outlay, but it is also subject to restrictions placed on how the business may be operated by the investors buying the issue. Moreover, public issues are expensive in terms of administrative, marketing, and regulatory reporting costs. These reasons explain why asset-based lending has emerged as an attractive alternative to using cash, stock, or public debt issues, if the target has sufficient tangible assets to serve as collateral.

**Asset-Based or Secured Lending**

Under asset-based lending, the borrower pledges certain assets as collateral. Asset-based lenders look at the borrower’s assets as their primary protection against the borrower’s failure to repay. These loans are often short term (i.e., less than one year in maturity) and secured by assets that can be liquidated easily, such as accounts receivable and inventory. Borrowers often seek revolving lines of credit that they draw upon on a daily basis to run their business. Under a revolving credit arrangement, the bank agrees to make loans up to a specified maximum for a specified period, usually a year or more. As the borrower repays a portion of the loan, an amount equal to the repayment can be borrowed again under the terms of the agreement. In addition to interest on the notes, the bank charges a fee for the commitment to hold the funds available. For a fee, the borrower may choose to convert the revolving credit line into a term loan. A term loan usually has a maturity of 2 to 10 years and typically is secured by the asset that is being financed, such as new capital equipment.

Acquiring firms often prefer to borrow funds on an unsecured basis because the added administrative costs involved in pledging assets as security significantly raise the total cost of borrowing. Secured borrowing can be onerous because the security agreements can severely limit a company’s future borrowing and ability to pay dividends, make investments, and manage working capital aggressively. In many instances, though, borrowers may have little choice but to obtain secured lending for at least a portion of the purchase price. Asset-based lenders generally require personal guarantees from the buyer such as pledging a personal asset (e.g., the buyer’s primary residence). This is especially true in small transactions if the buyer does not have a demonstrated track record of buying and operating businesses successfully.

**Loan Documentation**

The lending process entails some negotiation and results in several documents. The *loan agreement* stipulates the terms and conditions under which the lender will loan the firm funds; the *security agreement* specifies
which of the borrower’s assets will be pledged to secure the loan; and the *promissory note* commits the borrower to repay the loan, even if the assets, when liquidated, do not fully cover the unpaid balance. These agreements contain certain security provisions and protective covenants limiting what the borrower may do as long as the loan is outstanding. The security agreement is filed at a state regulatory office in the state where the collateral is located. Future lenders can check with this office to see which assets a firm has pledged and which are free to be used as future collateral. The filing of this security agreement legally establishes the lender’s security interest in the collateral. If the borrower defaults on the loan or otherwise fails to honor the terms of the agreement, the lender can seize and sell the collateral to recover the value of the loan.¹

**Pledging Receivables and Inventory**

Depending on the extent to which they are collectable, lenders may lend as much as 80 to 90 percent of the book value of the receivables.² Asset-based lenders generally are willing to lend against only those receivables due within 90 days and usually less than 100 percent of their value, because they are aware that some portion will not be collectable. Those that are more than 90 days past due are likely to be difficult to collect.

Inventories also are commonly used to provide collateral for leveraged buyout (LBO) transactions. Inventories (raw material, work-in-process, and finished goods), like receivables, can be highly liquid. Lenders generally consider only raw material and finished goods inventories as suitable collateral. The amount a lender will advance against the book value of inventory depends on its ease of identification and its liquidity. Typically, lenders will loan between 50 and 80 percent of the value of inventory and will tend to loan less if the inventory is perishable, is subject to rapid obsolescence, or has relatively few potential buyers.

**Pledging Equipment and Real Estate to Support Term Loans**

A term loan can be structured such that the period of the loan corresponds with the economic life of the item being financed, and borrowers often prefer these loans because there are no concerns about the loan needing to be renewed. Durable equipment and real estate often are used to secure term loans. Lenders are frequently willing to lend up to 80 percent of the appraised value of equipment (but not special-purpose equipment, which

¹ The process of determining which of a firm’s assets are free from liens is made easier today by commercial credit reporting repositories such as Dun & Bradstreet, Experian, Equifax, and TransUnion.
is likely to have few potential buyers) and 50 percent of the value of land. The cash flows generated by the assets will be used to pay off the loan.

Term loans are sometimes used in LBO transactions to reduce the overall cost of borrowing. Because they are negotiated privately between the borrower and lender, they can be much less costly than floating a public debt or stock issue.

**Security Provisions and Protective Covenants**

Security provisions and protective covenants in loan documents are intended to ensure that the principal and interest of outstanding loans will be repaid in a timely fashion. Typical security provisions include the assignment of payments due under a specific contract to the lender, an assignment of a portion of the receivables or inventories, and a pledge of marketable securities held by the borrower. Others include a mortgage on property, plant, and equipment held by the borrower, and the assignment of the cash surrender value of a life insurance policy held by the borrower on key executives.

An *affirmative covenant* in a loan agreement specifies the actions the borrowing firm agrees to take during the term of the loan. These actions typically include furnishing periodic financial statements to the lender, carrying sufficient insurance to cover insurable business risks, maintaining a minimum amount of net working capital, and retaining key management personnel acceptable to the lending institution. A *negative covenant* restricts the actions of the borrower. These actions include limiting the amount of dividends that can be paid, the level of salaries and bonuses that may be given to the borrower’s employees, the total amount of indebtedness that can be assumed by the borrower, investments in plant and equipment and acquisitions, and the sale of certain assets.

All loan agreements have default provisions permitting the lender to collect the loan immediately under certain conditions such as the borrower failing to pay interest, principal, or both according to the terms of the loan agreement; the borrower materially misrepresenting information on the firm’s financial statements; and the borrower failing to observe any of the affirmative or negative covenants. Loan agreements also typically have *cross-default provisions* that allow a lender to collect its loan immediately if the borrower is in default on a loan to another lender.

**Cash-Flow or Unsecured Lenders**

Cash-flow lenders view a borrower’s future cash-flow generation capability as the primary means of recovering a loan and the borrower’s assets as a secondary source of funds in the event of default by the borrower.
Cash-flow–based lending for LBOs became more commonplace during the mid-to-late 1980s. Many LBOs’ capital structures assumed increasing amounts of unsecured debt. To compensate for additional risk, the unsecured lenders would receive both a higher interest rate and warrants that were convertible into equity at some future date.

Unsecured debt that lies between senior debt and the equity layers is often referred to as **mezzanine financing**. It includes senior subordinated debt, subordinated debt, bridge financing, and LBO partnership financing. It frequently consists of high-yield junk bonds, which may also include zero coupon deferred interest debentures (i.e., bonds whose interest is not paid until maturity) used to increase the postacquisition cash flow of the acquired entity. In liquidation, unsecured debt lies between the secured or asset-based debt and preferred and common equity. Unsecured financing often consists of several layers of debt, each subordinate in liquidation to the next most senior issue. Those with the lowest level of security typically offer the highest yields to compensate for their higher level of risk in the event of default. **Bridge financing** is unsecured loans, often provided by investment banks or hedge funds, to supply short-term financing pending the placement of subordinated debt (i.e., long-term or “permanent” financing); the usual expectation is that bridge financing will be replaced six to nine months after the closing date of the LBO transaction.

**Types of Long-Term Financing**

The attractiveness of long-term debt is its relatively low after–tax cost as a result of the tax deductibility of interest. In addition, leverage can help improve earnings per share and returns on equity. However, too much debt can increase the risk of default on loan repayments and bankruptcy.

Long-term debt generally is classified according to whether it is secured. **Secured debt** issues typically are referred to as mortgage bonds or equipment trust certificates. **Debentures** are issues not secured by specific assets, and hence their quality depends on the general creditworthiness of the issuing company.

**Convertible Debt and Debentures**

Convertible bonds or debentures are types of debt that are convertible, at some predetermined ratio (i.e., a specific number of shares per bond), into shares of stock of the issuing company. Such debt often is referred to as a hybrid security because it has both debt and equity characteristics. It normally has a relatively low coupon rate (i.e., the fixed number of dollars to be paid each payment period as a percent of the value of the bonds when issued).
The bond buyer is compensated primarily by the ability to convert the bond to common stock at a substantial discount from the stock’s market value. Issuers of such debt benefit by having to make a lower cash interest payment. However, current shareholders will experience earnings or ownership dilution when the bondholders convert their bonds into new shares. For example, a shareholder not holding the convertible debt but owning 10 percent of the shares of a firm with one million shares outstanding will see that ownership position reduced to 5 percent if one million new shares are issued, due to the conversion of such debt into equity.

**Senior and Junior Debt**

Long-term debt issues also are classified by whether they are senior or junior in liquidation. Senior debt has a higher-priority claim to a firm’s earnings and assets than junior debt. Unsecured debt also may be classified according to whether it is subordinated to other types of debt. In general, subordinated debentures are junior to other types of debt, including bank loans, and even may be junior to all of a firm’s other debt.

**Indentures**

The extent to which a debt issue is junior to other debt depends on the restrictions placed on the company in an agreement called an indenture, which is a contract between the firm that issues the long-term debt securities and the lenders. The indenture details the nature of the issue, specifies the way in which the principal must be repaid, and specifies affirmative and negative covenants applicable to the long-term debt issue. Typical covenants include maintaining a minimum interest coverage ratio, minimum level of working capital, maximum amount of dividends that the firm can pay, and restrictions on equipment leasing and issuing additional debt.

**Bond Ratings**

Debt issues are rated by various rating agencies according to their relative degree of risk. The agencies consider a variety of factors, including a firm’s earnings stability, interest coverage ratios, the relative amount of debt in the firm’s capital structure, the degree of subordination of the issue being rated, and the firm’s past performance in meeting its debt service requirements.³

³ Rating agencies include Moody’s Investors Services and Standard & Poor’s Corporation. Each has its own scale for identifying the risk of an issue. For Moody’s, the ratings are Aaa (the lowest risk category), Aa, A, Baa, Ba, B, Caa, Ca, and C (the highest risk). For S&P, AAA denotes the lowest risk category, and risk rises progressively through ratings AA, A, BBB, BB, B, CCC, CC, C, and D.
Junk Bonds

_Junk bonds_ are high-yield bonds that credit-rating agencies have deemed either to be below investment grade or that they have not rated at all. When originally issued, junk bonds frequently yielded more than four percentage points above the yields on U.S. Treasury debt of comparable maturity.

Junk bond financing exploded at the beginning of the 1980s but dried up by the end of the decade. About three-fourths of the total proceeds of junk bonds issued between 1980 and 1986 were used to finance the capital requirements of high-growth corporations; the remainder was used to finance takeovers.

Leveraged Bank Loans

_Leveraged loans_ are often defined as unrated or noninvestment-grade bank loans whose interest rates are equal to or greater than the London Interbank Rate (LIBOR) plus 150 basis points (1.5 percentage points). Leveraged loans include second mortgages, which typically have a floating rate and give lenders a lower level of security than first mortgages. Some analysts include other forms of debt instruments in this market, such as mezzanine or senior unsecured debt, discussed earlier in this chapter, and payment-in-kind notes, for which interest is paid in the form of more debt.

In the United States, the volume of such loans substantially exceeds the volume of junk bond issues. This represents a revival in bank loan financing as an alternative to financing transactions with junk bonds after junk bond issues dried up in the late 1980s; at the time, bank loans were more expensive. Leveraged loans are often less costly than junk bonds for

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4 Moody’s usually rates noninvestment-grade bonds Ba or lower; for S&P, it is BB or lower.
5 Rapid growth of the junk bond market coincided with a growing deterioration during the 1980s in their quality, as measured by interest coverage ratios (i.e., earnings before interest and taxes/interest expense), debt/net tangible book value, and cash flow as a percentage of debt (Wigmore, 1994). Cumulative default rates for junk bonds issued in the late 1970s reached as high as 34 percent by 1986 (Asquith, Mullins, and Wolff, 1989), but firms that emerged from bankruptcy managed to recover some portion of the face value of the junk bond. Altman and Kishore (1996) found that recovery rates for senior secured debt averaged about 58 percent of the original principal and that the actual realized spread between junk bonds and 10-year U.S. Treasury securities was actually about four percentage points between 1978 and 1994, rather than more than four percentage points when they were issued originally. This source of LBO financing dried up in the late 1980s after a series of defaults of overleveraged firms, coupled with alleged insider trading and fraud at companies such as Drexel Burnham, the primary market maker for junk bonds at that time.
borrowers because they may provide a higher level of security than unsecured junk bonds.

Globally, the syndicated loan market (which includes leveraged loans, senior unsecured debt, and payment-in-kind notes) is growing more rapidly than public markets for debt and equity. Syndicated loans are those typically issued through a consortium of institutions, including hedge funds, pension funds, and insurance companies, to individual borrowers. Because such lending usually avoids the public debt markets, it often is referred to as the “private debt market.”

The “Road Show”

To arrange both bridge and permanent financing, the buyer will develop elaborate presentations to convince potential lenders of the attractiveness of the lending opportunity. It is referred to as a “road show” for good reason—immaculately dressed borrowers passionately display confidence in their business plan through carefully rehearsed and choreographed multimedia presentations in stuffy conference rooms throughout the country. The road show is an opportunity for potential lenders to see management and to ask tough questions. If the road show succeeds, at least several lenders will compete for all or a portion of the bond issue, resulting in lower interest rates and less onerous loan covenants.7

Assessing Risk Associated with Alternative Capital Structures

Computer models that simulate the financial impact of various financial structures on the combined firms are excellent tools for determining the appropriate capital structure. Although leverage raises the potential rate of return to equity investors, it also adds to risk. Increasing credit obligations to lenders implies increasing fixed interest expense, which raises the point at which the firm’s revenue covers its costs (i.e., its breakeven point). An unanticipated downturn in the economy or aggressive pricing actions by competitors can erode cash flow and the firm’s ability to meet

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7 Swiss drug manufacturer Roche Holdings conducted a European road show in early 2009 to arrange debt financing for the firm’s planned $42 billion buyout of the 44 percent of U.S. biotechnology firm Genentech it did not already own. Roche raised $10 billion from the public bond market, $25 billion from a syndicate of 12 banks, and planned to fund the remainder of the purchase price with its own cash and marketable securities. Additional short-term capital could be raised by issuing commercial paper (i.e., short-term debt-backed unsecured debt).
Financing Transactions

its interest expense, which could ultimately lead to bankruptcy. This risk can be measured by creating various scenarios, each representing a different capital structure and sales growth rate.

FINANCING OPTIONS: EQUITY AND HYBRID SECURITIES

In contrast to debt and preferred equity, income payments on common stock—which represents shareholder ownership in a corporation’s equity—can vary over time. The total return on capital stock reflects both the dividends paid as well as any capital appreciation due to increasing expected earnings and cash flow. Common stockholders participate in the firm’s future earnings because they may receive a larger dividend if earnings increase. If the corporation is forced to liquidate, however, common shareholders have rights to the firm’s assets only after bondholders and preferred stockholders are paid.

There are many varieties of common stock. Some pay dividends and offer voting rights, entitling the owner to participate in certain corporate decisions, such as electing members of the board of directors. Other common shares (often called supervoting shares) have multiple voting rights. In addition to voting rights, common shareholders sometimes receive rights offerings that allow them to maintain their proportional ownership in the company in the event that the company issues another stock offering. Common shareholders with rights may, but are not obligated to, acquire as many shares of the new stock as needed to maintain their proportional ownership in the company.

Like common stock, preferred stock is part of shareholders’ equity. Although preferred stockholders receive dividends rather than interest payments, their shares are considered a fixed income security. Dividends on preferred stock are generally constant over time, like interest payments on debt, but the firm is generally not obligated to pay them at a specific time. Unpaid dividends may cumulate for eventual payment by the issuer if the preferred stock is a special cumulative issue.

In liquidation, bondholders are paid first and then preferred stockholders; common stockholders are paid last. Its fixed income security status and this senior claim compared to common stock is why preferred stock often is issued to those providing equity in financing leveraged buyout transactions. To conserve cash, LBOs frequently issue paid-in-kind (PIK) preferred stock, where issuing additional par amounts of the preferred security can satisfy the dividend obligation.
SELLER FINANCING

Seller financing (also known as “owner financing” or “owner carry back”) is a highly important source of financing and one way to “close the gap” between what a seller wants and a buyer is willing to pay on the purchase price. This type of financing involves the seller deferring the receipt of a portion of the purchase price until some future date—in effect, providing a loan to the buyer. A buyer may be willing to pay the seller’s asking price if a portion is deferred because the buyer recognizes that the loan will reduce the purchase price in present or current value terms. The advantages to the buyer include a lower overall risk of the transaction, because of the need to provide less capital at the time of closing, and the shifting of operational risk to the seller if the buyer ultimately defaults on the loan to the seller.

Businesses that have excellent cash flow but very few tangible assets that can serve as collateral may find banks unwilling to lend. That may make seller financing a must.8

In a typical seller-financed transaction, the buyer contributes a large portion of the purchase price in cash and then negotiates with the seller a payback schedule and interest rate for the remaining balance. Sellers often are willing to carry a promissory note for some portion of the purchase price when the buyer is unable to get a bank loan or unwilling to put additional cash or equity in the purchase price.

Generally, seller financing is unsecured. If the business being purchased is part of a larger parent company, the borrower may be able to obtain certain concessions from the parent. For example, the parent may be willing to continue to provide certain products and services to the business at cost to increase the likelihood that the business can repay its note in a timely fashion.

Sellers may use their willingness to provide such financing as a way to market their business when it is difficult for buyers to obtain financing. By offering to finance a portion of the purchase price, a seller makes an implicit commitment to the buyer that shows confidence in the current and continuing financial viability of the business. It is this confidence that drives the willingness to take on a portion of the risk.

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8 Many businesses do not want to use seller financing because it requires that they accept the risk that the note will not be repaid. Such financing is necessary, though, when bank financing is not an option. The drying up of bank lending in 2008 and 2009 due to the slumping economy and crisis of confidence in the credit markets resulted in increased reliance on seller financing to complete the sale of small- to intermediate-size businesses.
Exhibit 9-1 summarizes the alternative forms of financing by type of security and source of funds.

### HIGHLY LEVERAGED TRANSACTIONS

The *leveraged buyout*, or LBO, is a common example of a highly leveraged transaction in which a large portion of the purchase price is financed with debt. LBO targets can be private or public firms, and can involve an entire company or a division of a company. An LBO investor is often called a *financial buyer* or sponsor and may be inclined to use a large amount of debt to finance as much of the target’s purchase price as possible. Financial buyers tend to concentrate on actions that enhance the target firm’s ability

<table>
<thead>
<tr>
<th>Alternative Types</th>
<th>Debt</th>
<th>Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset-Based Lending</td>
<td>Revolving Credit Lines</td>
<td>Common Stock</td>
</tr>
<tr>
<td></td>
<td>Term Loans</td>
<td>Preferred Stock</td>
</tr>
<tr>
<td></td>
<td>Sale/Lease-Back</td>
<td></td>
</tr>
<tr>
<td>Cash-Flow-Based Lending</td>
<td>Deferred Payments</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Earnouts</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Installment Sales</td>
<td></td>
</tr>
<tr>
<td>Seller Financing</td>
<td>Senior</td>
<td>Hedge or Buyout Funds</td>
</tr>
<tr>
<td></td>
<td>Convertible</td>
<td>Private Equity Investors</td>
</tr>
<tr>
<td></td>
<td>Subordinated</td>
<td>Venture Capital</td>
</tr>
<tr>
<td></td>
<td>Commercial Banks</td>
<td>Strategic Investors</td>
</tr>
<tr>
<td></td>
<td>Insurance Companies</td>
<td>Individual Investors</td>
</tr>
<tr>
<td></td>
<td>Pension Funds</td>
<td>(“Angels”)</td>
</tr>
<tr>
<td></td>
<td>Investment/Merchant Banks</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Hedge Funds and Private</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Equity Partnerships</td>
<td></td>
</tr>
<tr>
<td>Public Offering and Private Placements</td>
<td>Revolving Credit Lines</td>
<td>Common Stock</td>
</tr>
<tr>
<td></td>
<td>Term Loans</td>
<td>Preferred Stock</td>
</tr>
<tr>
<td></td>
<td>Sale/Lease-Back</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Senior</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Convertible</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Subordinated</td>
<td></td>
</tr>
<tr>
<td>Alternative Sources</td>
<td>Commercial Banks</td>
<td>Hedge or Buyout Funds</td>
</tr>
<tr>
<td></td>
<td>Insurance Companies</td>
<td>Private Equity Investors</td>
</tr>
<tr>
<td></td>
<td>Pension Funds</td>
<td>Venture Capital</td>
</tr>
<tr>
<td></td>
<td>Investment/Merchant Banks</td>
<td>Strategic Investors</td>
</tr>
<tr>
<td></td>
<td>Hedge Funds and Private</td>
<td>Individual Investors</td>
</tr>
<tr>
<td></td>
<td>Equity Partnerships</td>
<td>(“Angels”)</td>
</tr>
</tbody>
</table>
to generate cash to satisfy their substantial debt service requirements. High leverage makes the potential returns to equity much more attractive than less-leveraged transactions (see Exhibit 9-2).

The funds borrowed for a leveraged buyout are used to pay for most of the purchase price, with the remainder provided by a financial sponsor, such as a private equity investor group or hedge fund. Typically, the tangible assets of the firm to be acquired are used as collateral for the loans in a leveraged buyout, with the most highly liquid assets—such as receivables and inventory—used for collateral to obtain bank financing and fixed assets used to secure a portion of long-term senior financing. Subordinated debt (often junk bond financing), either unrated or low-rated debt, is used to raise the balance of the purchase price.

When a public company is subject to an LBO, it is said to be going private in a public-to-private transaction, because the equity of the firm has been purchased by a small group of investors and is no longer publicly traded. The buying group of the firm targeted to become a leveraged buyout often comprises incumbent managers from that very firm in what is called a management buyout (MBO).

Although private equity investors and hedge funds played an important role as financial sponsors (i.e., equity investors) in highly leveraged transactions throughout the three merger waves since the early 1980s, their role was largely a secondary one during the 1990s tech boom. The buyout

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**EXHIBIT 9-2 Impact of Leverage on Return to Shareholders**

<table>
<thead>
<tr>
<th>Description</th>
<th>All-Cash Purchase</th>
<th>50% Cash/50% Debt</th>
<th>20% Cash/80% Debt</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase Price</td>
<td>$100</td>
<td>$100</td>
<td>$100</td>
</tr>
<tr>
<td>Equity (Cash Investment)</td>
<td>$100</td>
<td>$50</td>
<td>$20</td>
</tr>
<tr>
<td>Borrowings</td>
<td>0</td>
<td>$50</td>
<td>$80</td>
</tr>
<tr>
<td>Earnings Before Interest and Taxes</td>
<td>$20</td>
<td>$20</td>
<td>$20</td>
</tr>
<tr>
<td>Interest @ 10%</td>
<td>0</td>
<td>$5</td>
<td>$8</td>
</tr>
<tr>
<td>Income Before Taxes</td>
<td>$20</td>
<td>$15</td>
<td>$12</td>
</tr>
<tr>
<td>Less Income Taxes @ 40%</td>
<td>$8</td>
<td>$6</td>
<td>$4.8</td>
</tr>
<tr>
<td>Net Income</td>
<td>$12</td>
<td>$9</td>
<td>$7.2</td>
</tr>
<tr>
<td>After-Tax Return on Equity</td>
<td>12%</td>
<td>18%</td>
<td>36%</td>
</tr>
</tbody>
</table>

*Unless otherwise noted, all numbers are in millions of dollars.
bิง came to a grinding halt when LBO financing dried up in late 2007 and throughout 2008.9

Exhibit 9-3 summarizes the types of securities and sources of funding often used to finance an LBO.

FINANCING TRANSACTIONS BY SELLING DISCRETIONARY ASSETS

Target firm assets not considered critical to implementing the acquirer’s business strategy could be sold to finance the purchase of the target firm. Obviously, the best time to sell a business is when the owner does not need to sell, or when the demand for the business to be divested is greatest. The decision to sell should also reflect the broader financial environment. Selling when business confidence is high, stock prices are rising, and interest rates are low is likely to fetch a higher price. If a business to be sold is highly cyclical, the sale should be timed to coincide with the firm’s peak year earnings. Businesses also can be timed to sell when they are considered most popular. In 1980, the oil exploration business was booming; by 1983, it was in the doldrums. It recovered again by the mid-1990s. What’s hot today can fizzle tomorrow. A similar story could be told about many of the high-flying Internet-related companies of the late 1990s and with commodity firms in 2008 through 2010.

The selling process may be reactive or proactive. Reactive sales occur when a buyer unexpectedly approaches the parent with interest in either the entire firm or a portion of the firm, such as a product line or subsidiary. If the bid is sufficiently attractive, the parent firm may choose to reach a negotiated settlement with the bidder without investigating other options.

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9 LBO transactions surged in the 1980s, culminating in the $31.5 billion (including assumed debt) buyout in 1988 of RJR Nabisco by Kohlberg Kravis Roberts & Co. This boom period dissipated due to the 1991 recession and political backlash against such transactions. Following the late-1990s tech booms, the 9/11 terrorist attacks, and the 2001 recession, highly leveraged transactions once again surged upward, peaking in early 2007—fueled largely by a strong economy, low interest rates, and easy credit conditions. When the boom came to a halt in late 2007 and early 2008, it forced private equity and hedge funds to retrench and—as a sign of the times—there were 91 defaults globally totaling $295 billion by private equity-backed companies during 2008 (according to Standard & Poor’s). Reflecting the perceived risk associated with highly leveraged transactions, high-yield spreads (i.e., the difference between high-risk corporate debt and U.S. Treasury bond rates) reached record levels in late 2008 of more than 17 percentage points, more than twice their historical average.
EXHIBIT 9-3  Leveraged Buyout Capital Structure

<table>
<thead>
<tr>
<th>Type of Security</th>
<th>Lenders Loan Up To</th>
<th>Lending Source</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Secured Debt</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>– Short-Term (&lt;1 Year) Debt</td>
<td>50–80% depending on quality</td>
<td>Banks and finance companies</td>
</tr>
<tr>
<td>– Intermediate-Term (1–10 Years) Debt</td>
<td>Up to 80% of appraised value of equipment and 50% of real estate</td>
<td>Life insurance companies, private equity investors, pension and hedge funds</td>
</tr>
<tr>
<td><strong>Unsecured or Mezzanine Debt</strong> (Subordinated and Junior Subordinated Debt, including Seller Financing)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>– First Layer</td>
<td></td>
<td></td>
</tr>
<tr>
<td>– Second Layer</td>
<td></td>
<td></td>
</tr>
<tr>
<td>– Etc.</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Bridge Financing</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Payment-in-Kind</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Equity</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Preferred Stock</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>– Payment-in-Kind</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Common Stock</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

- Liens generally on receivables and inventories
- Liens on land and equipment
- 50–80% depending on quality
- Up to 80% of appraised value of equipment and 50% of real estate
- 50–80% depending on quality
- Up to 80% of appraised value of equipment and 50% of real estate
- Banks and finance companies
- Life insurance companies, private equity investors, pension and hedge funds
- Life insurance companies, pension funds, private equity, and hedge funds
- Life insurance companies, pension funds, private equity, and hedge funds
- Life insurance companies, pension, private equity, hedge, and venture capital funds; and angel investors

Cash-generating capabilities of the borrower

Face value of securities

Life insurance companies, pension funds, private equity, and hedge funds

Life insurance companies, pension funds, private equity, and angel investors

Life insurance companies, pension, private equity, hedge, and venture capital funds; and angel investors

Cash-generating capabilities of the borrower

Life insurance companies, pension, private equity, hedge, and venture capital funds; and angel investors
This may occur if the parent is concerned about potential degradation of its business, or that of a subsidiary, if its interest in selling becomes public knowledge.

In contrast, proactive sales may be characterized as public or private solicitations. In a public solicitation, a firm can announce publicly that it is putting itself, a subsidiary, or a product line up for sale. Potential buyers then contact the seller. This is a way to identify interested parties relatively easily. Unfortunately, this approach can also attract unqualified bidders who lack the financial resources necessary to complete the deal. In a private solicitation, the parent firm may hire an investment banker or undertake on its own to identify potential buyers. When a list of perceived qualified buyers is compiled, contact is made. (Chapter 7 details this screening and contacting process.)

In either a public or private solicitation, interested parties are asked to sign confidentiality agreements before being given access to proprietary information. In a private solicitation, they may also be asked to sign a standstill agreement requiring them not to make an unsolicited bid. Parties willing to sign these agreements are then asked to submit preliminary, non-binding “indications of interest” (i.e., a single number or a bid expressed as a range). Parties that submit preliminary bids are then ranked by the selling company in terms of bid size, form of payment (i.e., composition), the ability of the bidder to finance the transaction, form of acquisition (i.e., whether the bidder proposes to buy stock or assets), and ease of doing the deal. The latter factor involves an assessment of the difficulty in obtaining regulatory approval, if required, and of the integrity of the bidder. A small number of those submitting preliminary bids are then asked to submit a best and final offer (BAFO). Such offers must be binding on the bidder. At this point, the seller may choose to initiate an auction among the most attractive bids or go directly into negotiating a purchase agreement with a single party.

**ESTIMATING THE IMPACT OF ALTERNATIVE FINANCING STRUCTURES**

To estimate the impact of alternative financing structures, the consolidated target and acquiring firms’ financial statements—adjusted to reflect the net effects of synergy—are run through a series of scenarios to determine how they affect variables such as earnings, leverage, covenants, and borrowing costs. For example, each scenario could represent different amounts of leverage as measured by the firm’s debt-to-equity ratio.
Selecting the Appropriate Capital or Financing Structure

In theory, the optimal capital or financing structure is the one that maximizes the firm’s share price or market value (i.e., the number of shares outstanding times the price per share). Reinvesting borrowed funds at a return above the firm’s cost of capital (i.e., the minimum financial return required by investors and lenders) increases the firm’s market value because demand for the firm’s shares increases. However, higher debt levels also increase the minimum financial return investors require to invest in the increasingly leveraged firm as the potential for bankruptcy increases. Assuming the firm does not improve its expected financial returns, the increased leverage could lower the firm’s share price as investors sell the firm’s shares in anticipation of the firm’s inability to make future interest and principal repayments. Because many factors affect share price, it is difficult to determine the exact capital structure that maximizes the firm’s share price.

In practice, financial managers attempt to forecast how changes in debt will affect those credit ratios that affect a firm’s creditworthiness. Factors include the interest coverage ratio (i.e., pretax and interest operating income/interest expense), debt-to-equity ratio, current ratio (i.e., current assets less current liabilities), and so on. Managers then discuss their projected pro forma financial statements (i.e., projected financial statements) with lenders and bond rating agencies, who may make adjustments to the firm’s projected financial statements and who then compare the firm’s credit ratios with those of other firms in the same industry to assess the likelihood that the borrower will be able to repay the borrowed funds (with interest) on schedule. Ultimately, this interaction among borrower, lenders, and rating agencies determines the amount and composition of the combined firms’ capital structure (i.e., the acquirer’s and target’s combined amount of debt relative to equity).  

Buyers often build financial models to determine the appropriate financing structure. The appropriate structure can be estimated by selecting that structure which satisfies certain predetermined selection criteria. These selection criteria should be determined as part of the process of

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10 Credit-rating agencies’ fees today are paid by the very firms whose creditworthiness they analyze—a potential conflict of interest. The failure of these agencies in 2008 and 2009 to anticipate the huge surge in corporate defaults and bankruptcies underscores the limitations of this practice. Agencies can give top investment ratings to those that pay the highest fees and can find even the most exotic forms of financing acceptable even when their structures may be problematic. Some observers argue that this is how mega-insurance company AIG maintained the highest credit ratings well into 2008, despite having issued billions of dollars in credit default swap contracts without maintaining adequate reserves.
developing the acquisition plan. The acquirer—whether a private or public company—should select the financing structure that enables three criteria to be satisfied: the acquirer is able to achieve its financial return objectives for the combined companies; it meets the primary needs of the acquirer and target firm’s shareholders; and there is no significant increase in the cost of debt or violation of loan covenants. For public companies, an added criterion should be that earnings per share dilution, if any, is minimized, and reductions in reported financial returns are temporary.

The financial return objectives of publicly traded companies are often couched in terms readily understood by investors, such as earnings per share. Acquiring companies must be able to convince investors that any EPS dilution is temporary and that the long-term EPS growth of the combined companies will exceed what the acquirer could have achieved without the acquisition. Financial returns for both public and private companies also may be described as the firm’s estimated cost of capital, or in terms of the return on total capital (i.e., debt plus equity), assets, or equity. Moreover, the combined companies’ cash flow must be sufficient to meet any incremental interest and principal repayments resulting from borrowing undertaken to finance all or some portion of the purchase price, without violating existing loan covenants or deviating from debt service ratios typical for the industry. If loan covenants are violated, lenders may require the combined companies to take immediate remedial action or be declared in technical default and forced to repay the outstanding loans promptly. Further, if the combined firms’ interest coverage or debt-to-equity ratios deviate significantly from what is considered appropriate for similar firms in the same industry, borrowing costs may escalate sharply.

The Importance of Stating Assumptions

The credibility of any valuation ultimately depends on the validity of its underlying assumptions. Valuation-related assumptions tend to fall into five major categories. **Market assumptions** are generally those that relate to the growth rate of unit volume and product price per unit. **Income statement assumptions** include the projected growth in revenue, the implied market share (i.e., the firm’s projected revenue as a percent of projected industry revenue), and the growth in the major components of cost in relation to sales. **Balance sheet assumptions** may include the growth in the primary components of working capital, and fixed assets in relation to the projected growth in sales. Note that implicit assumptions about cash flow already
are included in assumptions about the income statement and changes in the balance sheet, which together drive changes in cash flow. **Synergy assumptions** relate to the amount and timing associated with each type of anticipated synergy, including cost savings from workforce reductions, productivity improvements as a result of the introduction of new technologies or processes, and revenue growth as a result of increased market penetration or cross-selling opportunities. Finally, examples of important **valuation assumptions** include the acquiring firm’s target debt-to-equity ratio used in calculating the cost of capital, the discount rates used during the forecast and stable growth periods, and the growth assumptions used in determining the terminal value.

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No matter the size or composition of the offer price, lenders and equity investors will want to see a coherent analysis of why the proposed transaction is a good investment opportunity. Lenders will want assurances that they will be repaid on a timely basis and at a rate that will compensate them for the perceived risk of the deal. Similarly, equity investors will require some degree of confidence that they will be rewarded adequately for the risk they would be assuming, especially because they are subordinate to lenders in the event the firm is ultimately liquidated. Consequently, the financing plan is combined with the acquirer’s business and acquisition plans and used to negotiate the best possible terms for the proposed transaction.

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**A Case in Point: Financing LBOs—The SunGard Transaction**

With their cash hoards accumulating at an unprecedented rate, there was little that buyout firms could do but to invest in larger firms. Consequently, the average size of LBO transactions grew significantly during 2005. Late that year, seven private investment firms banded together as an investor group and acquired 100 percent of the outstanding stock of SunGard Data Systems Inc., a financial software firm known for providing application and transaction software services and creating backup data systems in the event of disaster. As a single buyer group, the firms—Silver Lake Partners, Bain Capital, The Blackstone Group, Goldman Sachs Capital Partners, Kohlberg Kravis Roberts & Co., Providence Equity Partners, and Texas Pacific Group—spread the risk of such a large deal and reduced the likelihood of a bidding war. It was a move reminiscent of the blockbuster buyouts of the late 1980s.
SunGard’s software manages 70 percent of the transactions made on the NASDAQ stock exchange, but its biggest business is creating backup data systems in case a client’s main systems are disabled by a natural disaster, blackout, or terrorist attack. Its large client base for disaster-recovery and backup systems provides a substantial and predictable cash flow. The software side of SunGard is believed to have significant growth potential, while the disaster-recovery side provides a large, stable cash flow.

Unlike many LBOs, the deal was announced as being all about growth of the financial services software side of the business. It was structured as a merger, because SunGard was to be merged into a shell corporation created by the buyer group. Going private would allow SunGard to invest heavily in software without being punished by investors because such investments are expensed and reduce reported earnings per share. Going private would also allow the firm to eliminate the burdensome reporting requirements of being a public company.

The buyout represented a potentially significant source of fee income for the investor group. In addition to the 2 percent management fees buyout firms collect from investors in the funds they manage, they receive substantial fee income from each investment they make on behalf of their funds. For example, the buyout firms receive a 1 percent deal completion fee, which was more than $100 million in the SunGard transaction. Buyout firms also receive fees for arranging financing, paid for by the target firm that is “going private.” Moreover, there are fees for conducting due diligence and for monitoring the ongoing performance of the firm taken private. Finally, when the buyout firms exit their investments in the target firm via a sale to a strategic buyer or a secondary IPO, they receive 20 percent (i.e., so-called carry fee) of any profits.

Under the terms of the agreement, SunGard shareholders received $36 per share, a 14 percent premium over the SunGard closing price as of the announcement date of March 28, 2005, and 40 percent more than when the news first leaked about the deal a week earlier. From the SunGard shareholders’ perspective, the deal was valued at $11.4 billion dollars: $10.9 billion for outstanding shares and “in-the-money” options (i.e., options whose exercise price is less than the firm’s market price per share), plus $500 million in debt on the balance sheet.

The seven equity investors provided $3.5 billion in capital, with the remainder of the purchase price financed by commitments from a lending consortium comprising Citigroup, JPMorgan Chase & Co., and Deutsche Bank. The loans financed the merger and were to be used to repay or refinance SunGard’s existing debt, provide ongoing working capital, and pay fees and expenses incurred in connection with the merger. The total funds necessary to complete the merger, and related fees and expenses, were approximately $11.3 billion, consisting of approximately $10.9 billion to pay SunGard’s stockholders and about
$400.7 million to pay fees and expenses related to the merger and the financing arrangements (comprising nearly 4 percent of the purchase price). Ongoing working capital needs and capital expenditures required obtaining commitments from lenders well in excess of $11.3 billion.

The merger financing comprised several tiers of debt and “credit facilities” (i.e., arrangements for extending credit). The senior secured debt and senior subordinated debt were intended to provide “permanent” or long-term financing. Senior debt covenants included restrictions on new borrowing, investments, sales of assets, mergers and consolidations, prepayments of subordinated indebtedness, capital expenditures, liens and dividends and other distributions, as well as a minimum interest coverage ratio and a maximum total leverage ratio.

As part of the deal, the banks providing the financing committed to making up to $3 billion in loans under a senior subordinated bridge credit facility if the offering of notes was not completed on or prior to the closing. The bridge loans were intended as a form of temporary financing to satisfy immediate cash requirements until permanent financing could be arranged. A special-purpose SunGard subsidiary would purchase receivables from SunGard, with the purchases financed through the sale of the receivables to the lending consortium. The lenders subsequently financed the purchase of the receivables by issuing commercial paper, which is repaid as the receivables are collected. Based on the value of receivables at closing, the subsidiary could have provided up to $500 million. The obligation of the lending consortium to buy the receivables was negotiated to expire on the sixth anniversary of the closing of the merger.

Things to Think About:
1. SunGard is a software company with relatively few tangible assets. Yet, the ratio of debt to equity is almost 5 to 1. Why do you think lenders would be willing to engage in such a highly leveraged transaction for a firm of this type?
2. Under what circumstances would SunGard refinance the existing $500 million in outstanding senior debt after the merger? Be specific.
3. In what ways is this transaction similar to and different from those common in the 1980s? Be specific.
4. Why are payment-in-kind securities (e.g., debt or preferred stock) particularly well suited for financing LBOs? Under what circumstances might they be most attractive to lenders or investors?
5. Explain how the way in which the LBO is financed affects the way it is operated and the timing of when equity investors choose to exit the business. Be specific.

Answers can be found at: www.elsevierdirect.com/companion.jsp?ISBN=9780123749482
M&A Postmerger Integration

After a transaction closes, integration is on the agenda. The category into which the acquirer falls will influence considerably the extent of integration and the pace at which it takes place. Financial buyers—those who buy a business for eventual resale—tend not to integrate the acquired business into another entity. Rather than manage the business, they are inclined to monitor the effectiveness of current management and intervene only if there is a significant and sustained deviation between actual and projected performance. In contrast, strategic buyers want to make a profit by managing the acquired business for an extended period, either as a separate subsidiary in a holding company or by merging it into another business.

For our purposes here, assume that integration is the goal of the acquirer immediately after the transaction closes. The integration phase is an important contributor to the ultimate success of the merger or acquisition, and ineffective integration is commonly given as one of the reasons M&As fail to meet or exceed expectations. A practical process makes for effective integration. The critical success factors include planning carefully prior to the merger, maintaining candid and continuous communication, adopting the right pace for combining the businesses, appointing an integration manager and team with clearly defined goals and lines of authority, and making the difficult decisions early in the process.

THE ROLE OF INTEGRATION IN SUCCESSFUL MERGERS AND ACQUISITIONS

Rapid integration is more likely to result in a merger that achieves the acquirer’s expectations. For our purposes, the term rapid is defined as relative to the pace of normal operations for a firm. Andersen Consulting studied 100 global acquisitions, each valued at more than $500 million, and concluded that most postmerger activities are completed within six months to one year and that integration done quickly generates the financial

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returns expected by shareholders and minimizes employee turnover and customer attrition.\(^2\)

**Realizing Projected Financial Returns**

A simple example demonstrates the importance of rapid integration to realizing projected financial returns. Suppose a firm’s current market value of $100 million accurately reflects the firm’s future cash flows discounted at its cost of capital (i.e., the financial return the firm must earn or exceed to satisfy the expectations of its shareholders and lenders). Assume an acquirer is willing to pay a $25 million premium for this firm over its current share price, believing it can recover the premium by realizing cost savings resulting from integrating the two firms. The amount of cash the acquirer will have to generate to recover the premium will increase the longer it takes to integrate the target company. If the cost of capital is 10 percent and integration is completed by the end of the first year, the acquirer will have to earn $27.5 million by the end of the first year to recover the control premium plus its cost of capital ($25 + $25 \times 0.10). If integration is not completed until the end of the second year, the acquirer will have to earn incremental cash flow of $30.25 million ($27.5 + $27.5 \times 0.10), and so on.

**The Impact of Employee Turnover**

Although there is little evidence that firms necessarily experience an actual reduction in their total workforce following an acquisition, there is evidence of increased turnover among management and key employees after a corporate takeover.\(^3\) Some loss of managers is intentional as part of an effort to eliminate redundancies and overlapping positions, but other managers quit during the integration turmoil. In many acquisitions, talent and management skills represent the primary value of the target company to the acquirer—especially in high-technology and service companies for which assets are largely the embodied knowledge of their employees\(^4\) — and it is difficult to measure whether employees who leave represent a significant “brain drain,” or loss of key managers. If this loss is significant, though, it degrades the value of the target company, making the recovery of any premium paid to target shareholders difficult for the buyer.

\(^2\) Andersen Consulting (1999).

\(^3\) Shivdasani (1993); Walsh (1989); Walsh and Ellwood (1991).

\(^4\) Lord and Ranft (2000).
The cost also may be high simply because the target firm’s top, experienced managers are removed as part of the integration process and replaced with new managers—who tend to have a high failure rate in general. When a firm selects an insider (i.e., a person already in the employ of the merged firms) to replace a top manager (e.g., CEO), the failure rate of the successor (i.e., the successor is no longer with the firm 18 months later) is 34 percent. When the board selects an outside successor (i.e., a person selected who is not in the employ of the merged firms) to replace the departing senior manager, the 18-month failure rate is 55 percent. Therefore, more than half of the time, an outside successor will not succeed, with an insider succeeding about two-thirds of the time.\(^5\)

The cost of employee turnover does not stop with the loss of key employees. The loss of any significant number of employees can be very costly. Current employees have already been recruited and trained; lose them, and you will incur new recruitment and training costs to replace them with equally qualified employees. Moreover, the loss of employees is likely to reduce the morale and productivity of those who remain.

**Acquisition-Related Customer Attrition**

During normal operations, a business can expect a certain level of churn in its customer list. Depending on the industry, normal churn as a result of competitive conditions can be anywhere from 20 to 40 percent. A newly merged company will experience a loss of another 5 to 10 percent of its existing customers as a direct result of a merger,\(^6\) reflecting uncertainty about on-time delivery and product quality and more aggressive post-merger pricing by competitors. Moreover, many companies lose revenue momentum as they concentrate on realizing expected cost synergies. The loss of customers may continue well after closing.\(^7\)

**Rapid Integration Does Not Mean Doing Everything at the Same Pace**

Rapid integration may result in more immediate realization of synergies, but it also contributes to employee and customer attrition. Therefore, intelligent

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\(^6\) Down (1995).

\(^7\) A McKinsey study of 160 acquisitions by 157 publicly traded firms in 11 different industries in 1995 and 1996 found that, on average, these firms grew four percentage points less than their peers during the three years following closing. Moreover, 42 percent of the sample actually lost ground. Only 12 percent of the sample showed revenue growth significantly ahead of their peers (Bekier, Bogardus, and Oldham, 2001).
integration involves managing these tradeoffs by quickly identifying and implementing projects that offer the most immediate payoff and deferring those whose disruption would result in the greatest revenue loss. Acquirers often will postpone integrating data processing and customer service call centers until much later in the integration process, if such activities are seen as pivotal to maintaining on-time delivery and high-quality customer service. Sometimes, significant differences in the corporate cultures of the acquirer and target firms will require a more measured pace of integration.

**Viewing Integration as a Process**

Six major activities are involved in integrating an acquired business into the acquirer’s operations, and some are logically sequential. They fall loosely into the following sequence: planning the premerger integration, resolving communication issues, defining the new organization, developing staffing plans, integrating functions and departments, and building a new corporate culture. Some activities, though, are continuous and, in some respects, unending. In practice, for instance, communicating with all major stakeholder groups and developing a new corporate culture are largely continuous activities, running through the integration period and beyond. Exhibit 10-1 outlines the sequence.

**PREMERGER INTEGRATION PLANNING**

Although some argue that integration planning should begin as soon as the merger is announced, assumptions made before the closing based on information accumulated during due diligence must be reexamined after the transaction is consummated to ensure their validity. The premerger integration planning process enables the acquiring company to refine its original estimate of the value of the target company and deal with transition issues in the context of the definitive agreement of purchase and sale. Furthermore, it gives the buyer an opportunity to insert into the agreement the appropriate representations (claims) and warranties (guarantees), as well as conditions of closing that facilitate the postmerger integration process. Finally, the planning process creates a postmerger integration organization to expedite the integration process following closing. It is important to include representatives from the negotiating team in the postmerger integration organization. As negotiators hand off to

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8 Carey and Ogden (2004).
EXHIBIT 10-1 Viewing Merger and Acquisition Integration as a Process

<table>
<thead>
<tr>
<th>Integration Planning</th>
<th>Developing Communication Plans</th>
<th>Creating a New Organization</th>
<th>Developing Staffing Plans</th>
<th>Functional Integration</th>
<th>Building a New Corporate Culture</th>
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<td>Premerger Planning:</td>
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<td>- Refine valuation</td>
<td>Stakeholders:</td>
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<td>Determine personnel</td>
<td>Revalidate due diligence data</td>
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<td>- Resolve transition issues</td>
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<td>- Negotiate contract assurances</td>
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- Business needs drive organizational structure
- Determine resource availability
- Conduct performance benchmarking
- Integrate through shared
  - Goals
  - Standards
  - Services
  - Space

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<th>Integration Planning</th>
<th>Developing Communication Plans</th>
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<th>Developing Staffing Plans</th>
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<th>Building a New Corporate Culture</th>
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<td>Establish staffing plans and timetables</td>
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<td>Develop compensation strategy Create supporting information systems</td>
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those responsible for postmerger integration, there is often a lack of shared understanding as to why certain items were included in the agreement, why others were excluded, and what certain contract terms mean.

To minimize potential confusion, it is critical to get the integration manager involved in the process as early as possible—ideally, as soon as the target has been identified or at least well before the evaluation and negotiation process begins.\(^9\) Doing so makes it more likely that the strategic rationale for the deal remains well understood by those involved in conducting due diligence and postmerger integration. (Chapter 8 provides further detail about the premerger integration planning process).

**Putting the Postmerger Integration Organization in Place before Closing**

A postmerger integration organization with clearly defined goals and responsibilities should be in place before closing. For friendly mergers, the organization—including supporting work teams—should comprise individuals from both the acquiring and target companies with a vested interest in the newly formed company. During a hostile takeover, of course, assembling such a team can be problematic, given the lack of trust that may exist between the parties to the transaction. The acquiring company will likely find it difficult to access needed information and involve the target company’s management in the planning process before the transaction actually closes.

If the plan is to integrate the target firm into one of the acquirer’s business units, it is critical to place responsibility for integration in that business unit. Personnel from the business unit should be well represented on the due diligence team to ensure they understand how best to integrate the target to realize synergies expeditiously.

**Postmerger Integration Organization: Composition and Responsibilities**

The postmerger integration organization should comprise a *management integration team* (MIT) and integration work teams focused on implementing a specific portion of the integration plan. Senior managers from the two merged organizations serve on the MIT, which is charged with implementing synergies identified during the preclosing due diligence. Involving senior managers from both firms captures the best talent from both

\(^9\) Uhlaler and West (2008).
organizations and also sends a comforting signal to all employees that there are decision makers involved who understand their particular situations.

The MIT’s emphasis during the integration period should be on activities that create the greatest value for shareholders. The team’s primary responsibility is to focus on key concerns such as long-term revenue, cost, and cash-flow performance targets, as well as product and customer strategies. Exhibit 10–2 summarizes the key tasks that should be performed by the MIT to realize anticipated synergies.

In addition to driving the integration effort, the MIT ensures that the managers not involved in the endeavor remain focused on running the business. Dedicated integration work teams perform the detailed integration work. These work teams should also include employees from both the acquiring and target companies. Other team members might include outside advisors, such as investment bankers, accountants, attorneys, and consultants.

The MIT allocates dedicated resources to the integration effort, clarifies nonteam membership roles, and enables day-to-day operations to continue at premerger levels. The MIT should be careful to give the work teams not only the responsibility to do certain tasks but also the authority and resources to get the job done. The teams should be encouraged to inject ideas into the process to foster creativity by encouraging solutions rather than by dictating

EXHIBIT 10-2  Key Management Integration Team
Responsibilities

1. Build a master schedule of what should be done by whom and by what date.
2. Determine the required economic performance for the combined entity.
3. Establish work teams to determine how each function and business unit will be combined (e.g., structure, job design, and staffing levels).
4. Focus the organization on meeting ongoing business commitments and operational performance targets during the integration process.
5. Create an early warning system consisting of performance indicators to ensure that both integration activities and business performance stay on plan.
6. Monitor and expedite key decisions.
7. Establish a rigorous communication campaign to support aggressively the integration plan. Address both internal (e.g., employees) and external (e.g., customers, suppliers, and regulatory authorities) constituencies.
processes and procedures. To be effective, the work teams must have access to timely, accurate information and should receive candid, timely feedback. The teams need to be kept informed of the broader perspective of the overall integration effort to avoid becoming too narrowly focused.

DEVELOPING COMMUNICATION PLANS FOR KEY STAKEHOLDERS

Before publicly announcing an acquisition, the acquirer should prepare a communication plan, developed jointly by the MIT and the public relations (PR) department or outside PR consultant. The plan should contain key messages and specify target stakeholders and appropriate media for conveying the messages to each group. Major stakeholder groups include employees, customers, suppliers, investors, lenders, communities, and regulators.

Employees: Addressing the “Me” Issues Immediately

Target firm employees typically represent a substantial portion of the acquired company’s value, particularly for technology and service-related businesses with few tangible assets. Therefore, preserving the value of an acquisition requires sensitivity to the timing, approach, and accuracy of whatever is communicated to employees.

The CEO should lead the effort to communicate to employees at all levels through onsite meetings or via teleconferencing. Communication to employees should be as frequent as possible; it is better to report that there is no change than to remain silent. Direct communication to all employees at both firms is critical. Deteriorating job performance and absences from work are clear signs of workforce anxiety, which may manifest not only among employees of the target firm but also among acquirer firm employees, who understand that most mergers will result in staff reductions across the board.

Many companies find it useful to create a single information source accessible to all employees, whether it is an individual whose job is to answer questions or a menu-driven automated phone system programmed to respond to commonly asked questions. The best way of communicating in a crisis, however, is to hold regularly scheduled employee meetings.

All external communication in the form of press releases should be coordinated with the public relations (PR) department to ensure that the same information is released concurrently to all employees. Internal e-mail systems, voicemail, or intranets may be used to facilitate employee communications.
In addition, personal letters, question-and-answer sessions, newsletters, or videos are highly effective ways to deliver messages.

Employees are interested in any information pertaining to the merger and how it will affect them. They want to know how changes affect the overall strategy, business operations, job security, working conditions, and total compensation. The human resources (HR) staff plays an important role in communicating to employees. Using surveys, interviews, focus groups, or employee meetings, HR representatives must learn what employees know and want to know, what the prevailing rumors are, and what employees find most disconcerting.

**Customers: Undercommitting and Overdelivering**

Some attrition is inevitable in an acquisition. It can be minimized if the newly merged firm commits to customers that it will maintain or improve product quality, on-time delivery, and customer service. Commitments should be realistic in terms of what needs to be accomplished during the integration phase. The firm must communicate to customers realistic benefits associated with the merger. From the customers’ perspective, the merger can increase the range of products or services offered or provide lower selling prices as a result of economies of scale and new applications of technology. The firm’s actions must support its talk.

**Suppliers: Developing Long-Term Vendor Relationships**

Just as a current customer is often worth more than a new one, so too is a current supplier with a proven track record. Although substantial cost savings are possible by “managing” suppliers, the new company should seek long-term relationships rather than simply ways to reduce costs. Aggressive negotiation may win high-quality products and services at lower prices in the short run, but that may be transitory if the new company is a large customer of the supplier and if the supplier’s margins are squeezed continually. The supplier’s product or service quality will suffer, and the supplier eventually may exit the business.

**Investors: Maintaining Shareholder Loyalty**

The new firm must be able to present to investors a compelling vision of the future. In a share-for-share exchange, there are compelling reasons for appealing to current investors of both the acquirer and target companies. Target shareholders will become shareholders in the newly formed company. Loyal shareholders tend to provide a more stable ownership base and
may contribute to lower share price volatility. All firms attract particular types of investors—some with a preference for high dividends and others for capital gains—and they may clash over their preferences, as America Online’s acquisition of Time Warner in January 2000 illustrates. The combined market value of the two firms lost 11 percent in the four days following the announcement, as investors fretted over what had been created and there was a selling frenzy that likely involved investors who bought Time Warner for its stable growth and America Online for its meteoric growth rate of 70 percent per year.

Communities: Building Strong, Credible Relationships

Good working relations with surrounding communities are simply good public relations. Companies should communicate plans to build or keep plants, stores, or office buildings in a community as soon as they can be confident that these actions will be implemented. Such steps often translate into new jobs and increased taxes for the community.

CREATING A NEW ORGANIZATION

Creating a new top team is highly challenging in the frenetic period immediately before or after closing. It must be done adroitly and expeditiously, despite that it can be a time-consuming process that involves appointing anywhere from 10 to 40 executives, including heads of key functions, groups, and even divisions. The combined firms’ new leaders must appoint the best possible top management team to achieve the new company’s goals. The role of each senior manager must be clearly defined to achieve effective collaboration.

Establishing a Structure

Traditionally, organization or structure is defined in terms of titles and reporting relationships—and that is the definition applicable here. A properly structured organization should support, not retard, the acceptance of a culture in the new company that is desired by top management. An effective starting point is to recognize that the needs of the business drive structure and not the other way around.

Building new reporting structures for combining companies requires knowledge of the target company’s prior organization, some sense as to the effectiveness of this organization in the decision-making process, and the future business needs of the newly combined companies. Therefore,
in creating the new organization, it is necessary to begin from previous organization charts. They provide insights into how individuals from both the target and acquiring companies will interact within the new company because they reveal the past experience and future expectations of individuals with regard to reporting relationships. The next step is to move from the past into the future by creating a structure that focuses on meeting the business needs of the combined companies.

There are three basic types of structures. In a **functional organization**, which tends to be the most centralized and is becoming less common, people are assigned to specific groups or departments such as accounting, engineering, marketing, sales, distribution, customer service, manufacturing, or maintenance. In a **product or service organization**, functional specialists are grouped by product line or service offering, and each has its own accounting, human resources, sales, marketing, customer service, and product development staffs. These types of organizations tend to be somewhat decentralized, and the individuals in them often have multiple reporting relationships, such as a finance manager reporting to a product line manager and the firm’s CFO. **Divisional organizations** continue to be the dominant form of organizational structure, in which groups of products are combined into independent divisions or “strategic business units.” Such organizations have their own management teams and tend to be highly decentralized.

The popularity of decentralized versus centralized management structures varies with the state of the economy. During recessions, when top management is under great pressure to cut costs, companies may tend to move toward centralized management structures, only to decentralize when the economy recovers. Highly decentralized authority can retard the pace of integration because there is no single authority to resolve issues or determine policies.

A centralized structure may make postmerger integration much easier. Senior management can dictate policies governing all aspects of the combined companies, centralize all types of functions that provide support to operating units, and resolve issues among the operating units. Still, centralized control can be highly detrimental and destroy value if policies imposed by the central headquarters are inappropriate for the operating units—such as policies that impose too many rigid controls, focus on the wrong issues, hire or promote the wrong managers, or establish the wrong performance measures. Moreover, centralized companies often have multiple layers of management and centralized functions providing services to the operating units. The parent companies pass the costs of centralized
management and support services on to the operating units, and these costs often outweigh the benefits.\textsuperscript{10}

The right structure may be an evolving one. The substantial benefits of a well-managed, rapid integration of two businesses suggest a centralized management structure initially with relatively few layers of management. In general, flatter organizations are becoming common among large companies. The distance between the CEO and division heads, measured in terms of intermediate positions, has decreased substantially, whereas the span of a CEO’s authority has widened.\textsuperscript{11} This does not mean that all integration activities should be driven from the top, with no input from middle managers and supervisors of both companies. It does mean taking decisive and timely action based on the best information available. When integration is viewed as relatively complete, the new company should move to a more decentralized structure in view of the well-documented costs of centralized corporate organizations.

**Developing Staffing Plans**

Staffing plans should be formulated as early as possible in the integration process. In friendly acquisitions, the process should begin before closing. The early development of such plans provides an opportunity to include key personnel from both firms in the integration effort. Other benefits include the increased likelihood of retaining employees with key skills and talents, maintaining corporate continuity, and building teams.

**Personnel Requirements**

The appropriate organizational structure is one that can meet the current functional requirements or needs of the business and is flexible enough to be expanded to satisfy future business requirements. The process for creating such a structure should involve input from all levels of management, be consistent with the combined firms’ business strategy, and reflect expected sales growth. Before establishing the organizational structure, the integration team should agree on the specific functions needed to run the combined businesses and then project each function’s personnel requirements based on a description of the function’s ideal structure to achieve its objectives. Input from department personnel at this stage can elicit useful insights and help build consensus for changing the organization.

\textsuperscript{10} Alexander, Campbell, and Gould (1995); Campbell, Sadler, and Koch (1997).

\textsuperscript{11} Wulf and Rajan (2003) reported a 25 percent decrease in intermediate positions between 1986 and 1999, with about 50 percent more positions reporting directly to the CEO.
Employee Availability
Employee availability refers to the number of each type of employee required by the new organization. The skills of the existing workforce should be documented and compared with the current and future functional requirements of the new company. The local labor pool can be a source of potential new hires for the combined firms to augment the existing workforce. Data should be collected on the educational levels, skills, and demographic composition of the local workforce, as well as prevailing wage rates by skill category.

Staffing Plans and Timetable
A detailed staffing plan can be developed after the preceding steps have been completed. Gaps in the firm’s workforce that need to be filled from outside recruitment can be readily identified. The effort to recruit externally should be tempered by its potentially adverse impact on current employee morale. Filling needed jobs should be prioritized and phased in over time in recognition of the time required to fill certain types of positions and the impact of major hiring programs on local wage rates in communities with a limited availability of labor.

After management positions have been filled, the managers should evaluate and select new employees to fill job openings in their departments and operations. Senior management should stress the importance of filling job openings, particularly when the skills required are crucial to completing the integration of the acquired business. During integration, managers are under the stress of having to conduct normal business operations as well as integrate portions of the acquired business.

The increased workload and assumption of additional responsibilities often lead managers to defer the time-consuming hiring process. This delay hurts manager morale and health and can stymie completion of the integration process because managers often are insufficiently trained to handle many of the responsibilities they have assumed. Key employees inevitably will be lost to the new company. Other employees should be trained to fill positions considered critical to the long-term viability of the organization. This can be accomplished by developing job descriptions that clearly identify the skills required to fill the positions and then by cross-training other workers in the positions.

Compensation
Merging compensation plans can be one of the most challenging activities of the integration process. It must be done in compliance with prevailing
regulations and with a high degree of sensitivity. Total compensation consists of base pay, bonuses or incentive plans, benefits, and special contractual agreements. Bonuses may take the form of a lump sum of cash or stock paid to an employee for meeting or exceeding certain targets. Special contractual agreements may consist of noncompete agreements in which key employees, in exchange for an agreed-on amount of compensation, sign agreements not to compete against the newly formed company if they should leave. Special agreements also may take the form of golden parachutes (i.e., lucrative severance packages) for senior management. Finally, retention bonuses often are given to employees if they agree to stay with the new company for a specific period.\(^\text{12}\)

The extent to which compensation plans are integrated depends on whether the two companies are going to be managed separately. Financial acquirers may be intent on reselling the acquired business in a few years and so may opt to keep compensation plans separate. The strategic acquirer also may keep the plans separate especially if it is moving into an industry in which compensation differs from that prevailing in its current industry. When the parent decides to combine plans, the design of a new plan generally is done in consultation with the acquired unit’s management. The parent will set guidelines, such as how much stock senior executives should own (e.g., a percentage of base pay) and how managers will receive the stock (e.g., whether they will be awarded stock or will have to buy it at a discount from its current market price). The parent will also set guidelines for base pay. For example, the parent may decide that base pay will be at market, below market, or above market adjusted for regional differences in the cost of living. Moreover, the parent may decide how bonuses will be paid, with the operating unit determining who receives them. Finally, the parent will determine the benefits policy and plans.

**Personnel Information Systems**

The acquiring company may choose to merge all personnel data into a new database, merge one corporate database into another, or maintain the separate personnel databases of each business. A single database enables authorized users to access employee data more readily, plan more efficiently for future staffing requirements, and conduct workforce analyses. Maintenance expense associated with a single database also may be lower.

\(^{12}\) Following its acquisition of Merrill Lynch in 2008, Bank of America offered Merrill’s top financial advisers retention bonuses to minimize potential attrition—believing that the loss of the highest producers among Merrill’s 17,000 brokers would have seriously eroded the value of the firm to Bank of America.
The decision to keep personnel databases separate may reflect plans to divest the unit at some time in the future.

**FUNCTIONAL INTEGRATION**

So far, you have learned about the steps involved in planning the integration process. Now let’s look at functional integration—the actual execution of the plans.

First, the management integration team must determine the extent to which the two companies’ operations and support staffs are to be centralized or decentralized. The main areas of focus should be information technology (IT), manufacturing operations, sales, marketing, finance, purchasing, research and development (R&D), and the requirements to staff these functions. However, before any actual integration takes place, it is crucial to revalidate data collected during due diligence and benchmark all operations by comparing them to industry standards.

**Revalidating Due Diligence Data**

Data collected during due diligence should be revalidated immediately after closing. The pressure exerted by both buyer and seller to complete the transaction often results in a haphazard preclosing due diligence review. For example, to compress the time devoted to due diligence, sellers often allow buyers access only to senior managers. Middle-level managers, supervisory personnel, and equipment operators may be excluded from the interview process. For similar reasons, site visits by the buyer often are limited to those sites with the largest number of employees; consequently, risks and opportunities that might exist at other sites are ignored or remain uncovered. The buyer’s legal and financial reviews typically are conducted only on the largest customer and supplier contracts, promissory notes, and operating and capital leases. Receivables are evaluated and physical inventory is counted using sampling techniques. The effort to determine whether intellectual property has been properly protected, with key trademarks or service marks registered and copyrights and patents filed, is often spotty.

**Benchmarking Performance**

Benchmarking important functions such as the acquirer and target manufacturing and IT operations and processes is a useful starting point for determining how to integrate these activities. Standard benchmarks include the International Organization for Standardization (ISO) 9000 Quality
Integrating Manufacturing Operations

The data revalidation process for integrating and rationalizing facilities and operations requires in-depth discussions with key target company personnel and onsite visits to all facilities. The objective should be to reevaluate overall capacity, the potential for future cost reductions, the age and condition of facilities, the adequacy of maintenance budgets, and compliance with environmental laws. The integration should consider carefully whether target facilities that duplicate manufacturing capabilities are potentially more efficient than those of the buyer. As part of the benchmarking process, the operations of both the acquirer and the target company should be compared with industry standards to properly evaluate their efficiency.

Process effectiveness is an accurate indicator of overall operational efficiency. Four processes should be examined. The first two are production planning and materials ordering. Production planning is often very inaccurate, particularly when the operations are not easily changed and require long-term sales forecasts. The production planning and materials ordering functions need to coordinate activities because the quantity and composition of the materials ordered depends on the accuracy of sales projections. Inaccurate projections result in shortages or costly excess inventory accumulation. The third process to examine, order entry, may offer significant opportunities for cost savings. Companies that produce in anticipation of sales often carry large finished goods inventories. For this reason, companies such as personal computer manufacturers are building inventory according to orders received to minimize working capital requirements. A key indicator of the effectiveness of quality control, the last of the processes to examine, is the percentage of products that go through the manufacturing process without being inspected. Companies whose “first run yield” (i.e., the percentage of finished products that do not have to be reworked due to quality problems) is in the 70 to 80 percent range may have serious quality problems.

13 Sanderson and Uzumeri (1997, p. 135) provided a comprehensive list of standards-setting organizations.
Plant consolidation begins by adopting a set of common systems and standards for all manufacturing activities. Such standards include cycle time between production runs, cost per unit of output, first-run yield, and scrap rates. Links between the different facilities are then created by sharing information management and processing systems, inventory control, supplier relationships, and transportation links. Vertical integration can be achieved by focusing on different stages of production. Different facilities specialize in the production of selected components, which are then shipped to other facilities to assemble the finished product. Finally, a company may close certain facilities whenever there is excess capacity.

**Integrating Information Technology**

IT spending constitutes an ever-increasing share of most business budgets—and about 80 percent of software projects fail to meet their performance expectations or deadlines.\(^\text{15}\) Nearly one-half are scrapped before completion, and about one-half cost two or three times their original budgets and take three times as long as expected to complete.\(^\text{16}\)

Managers seem to focus too much on technology and not enough on the people and processes that will use that technology. If the buyer intends to operate the target company independently, the information systems of the two companies may be kept separate as long as communications links between them can be established. If the buyer intends to integrate the target, though, the process can be daunting. Nearly 70 percent of buyers choose to combine their information systems immediately after closing, and almost 90 percent of acquirers eventually combine these operations.\(^\text{17}\)

**Integrating Finance**

Some target companies will be operated as standalone operations; others will be completely merged with the acquirer’s existing business. Many international acquisitions involve companies in areas that are geographically remote from the parent company and operate largely independently from the parent. This requires a great deal of effort to ensure that the buyer can monitor financial results from a distance, even if the parent has its representative permanently on site.

The acquirer should establish a budgeting process and signature approval levels to control spending. Signature approval levels refer to levels of

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\(^{16}\) *The Wall Street Journal* (November 18, 1996).

\(^{17}\) Cossey (1991).
expenditures that must be approved in writing by a designated manager; they will vary by the size of the firm. At a minimum, the budget should require projections of monthly cash inflows and outflows for the coming year.

**Integrating Sales**

Whether the sales forces of the two firms are wholly integrated or operated independently depends on their relative size, the nature of their products and markets, and their geographic location. A relatively small sales force may be readily combined with the larger sales force if they sell sufficiently similar products and serve sufficiently similar markets. The sales forces may be kept separate if the products they sell require in-depth understanding of the customers’ needs and a detailed knowledge of the product. It is quite common for firms that sell highly complex products such as robotics or enterprise software to employ a particularly well-trained and very sophisticated sales force that must employ the “consultative selling” approach; this may require keeping the sales forces of merged firms separate. Sales forces in globally dispersed businesses often are kept separate to reflect the uniqueness of their markets. However, support activities such as sales training or technical support often are centralized and used to support sales forces in several different countries.

Significant cost savings may be achieved by integrating sales forces, which eliminates duplicate sales representatives and related support expenses such as travel and entertainment expenses, training, and management. A single sales force may also minimize potential confusion by allowing customers to deal with a single sales representative when purchasing multiple products and services. Moreover, an integrated sales force may facilitate product cross-selling (i.e., the sale of one firm’s products to the other firm’s customers).

**Integrating Marketing**

Enabling the customer to see a consistent image in advertising and promotional campaigns may be the greatest challenge facing the integration of the marketing function. Steps to ensure consistency, however, should not confuse the customer by radically changing a product’s image or how it is sold.

The location and degree of integration of the marketing function depend on the global nature of the business, the diversity or uniqueness of product lines, and the pace of change in the marketplace. A business with operations worldwide may be inclined to decentralize marketing to the local countries to increase awareness of local laws and cultural patterns. Companies with a large number of product lines that can be grouped into
logical categories or that require extensive product knowledge may decide to disperse the marketing function to the various operating units to keep marketing personnel as close to the customer as possible.

**Integrating Purchasing**

Managing the merged firm’s purchasing function aggressively and efficiently can reduce the total cost of goods and services purchased by merged companies by 10 to 15 percent. The opportunity to reap such substantial savings from suppliers comes immediately after closing of the transaction. A merger creates uncertainty among both companies’ suppliers, particularly if they might have to compete against each other for business with the combined firms. Many will offer cost savings and new partnership arrangements, given the merged organization’s greater bargaining power to renegotiate contracts. The new company may choose to realize savings by reducing the number of suppliers. As part of the premerger due diligence, both the acquirer and the acquired company should identify a short list of their most critical suppliers, with a focus on those accounting for the largest share of purchased materials expenses.

**Integrating Research and Development**

R&D is an extremely important source of value in many M&As. Often, the buyer and seller R&D organizations are working on duplicate projects or projects not germane to the buyer’s long-term strategy. The integration team must define future areas of R&D collaboration and set priorities for future R&D research (subject to senior management approval).

Barriers to R&D integration abound. Some projects require considerably more time (measured in years) to produce results than others. Another obstacle is that some personnel stand to lose in terms of titles, prestige, and power if they collaborate. Finally, the acquirer’s and the target’s R&D financial return expectations may differ. The acquirer may wish to give R&D a higher or lower priority in the combined operation of the two companies.

A starting point for integrating R&D is to have researchers from both companies share their work with each other and co-locate. Work teams also can follow a balanced scorecard approach for obtaining funding for their projects, scoring R&D projects according to their impact on key

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18 Chapman et al. (1998), in an analysis of 50 M&As, found that companies were able to recover at least half of the premium paid for the target company by moving aggressively to manage their purchasing activities. For these firms, purchased goods and services, including office furniture, raw materials, and outside contractors, constituted up to 75 percent of the firms’ total spending.
stakeholders, such as shareholders and customers. Those projects receiving the highest scores are fully funded.

**Integrating Human Resources**

Traditionally, HR departments have been highly centralized and have been responsible for conducting opinion surveys, assessing managerial effectiveness, developing hiring and staffing plans, and providing training. HR departments are often instrumental in conducting strategic reviews of the strengths and weaknesses of potential target companies, integrating the acquirer’s and target’s management teams, recommending and implementing pay and benefit plans, and disseminating information about acquisitions. In recent years, as highly centralized HR functions have been found to be very expensive and nonresponsive, the trend has been to move the HR function to the operating unit, where hiring and training may be done more effectively. Most of the traditional HR activities are conducted at the operating units with the exception of the administration of benefit plans, management of HR information systems, and (in some cases) organizational development.\(^\text{19}\)

**BUILDING A NEW CORPORATE CULTURE**

*Corporate culture* is a common set of values, traditions, and beliefs that influence management and employee behavior within a firm. Large, diverse businesses have an overarching culture and a series of subcultures that reflect local conditions. When two companies with different cultures merge, the newly formed company often will take on a new culture quite different from either the acquirer’s or the target’s culture. Cultural differences are not inherently bad or good. They can instill creativity in the new company or create a contentious environment. Because speed in integrating the acquirer and target firms is critical to realizing anticipated synergies, dealing with potentially contentious cultural issues early in the integration process is crucial.

A firm’s culture takes both tangible and intangible forms. Tangible symbols of culture include statements hung on walls containing the firm’s mission and principles, as well as status associated with the executive office floor and designated parking spaces. Intangible forms include the behavioral norms communicated through implicit messages about how people are expected to act. Because they represent the extent to which employees

\(^{19}\) Porter & Wood (1998).
and managers actually “walk the talk,” these messages are often far more influential in forming and sustaining corporate culture than the tangible trappings of corporate culture.\textsuperscript{20}

Trust in the corporation is undermined immediately after a merger, in part by the ambiguity of the new organization’s identity. Employee acceptance of a common culture can build identification with and trust in the corporation. As ambiguity abates and acceptance of a common culture grows, trust can be restored, especially among those who closely identified with their previous organization.\textsuperscript{21}

**Identifying Cultural Issues through Cultural Profiling**

The first step in building a new corporate culture is to develop a cultural profile of both the acquirer and acquired companies through employee surveys and interviews and by observing management styles and practices. The information is then used to show the similarities and differences between the two cultures as well as their comparative strengths and weaknesses. A common difference is that one culture values individualism, whereas the other values teamwork.

The relative size and maturity of the acquirer and target firms can have major implications for cultural integration. Startup companies typically are highly unstructured and informal in terms of dress and decision making. Compensation may be largely stock options and other forms of deferred income. Benefits, beyond those required by state and federal law, and “perks” such as company cars are largely nonexistent. Company policies frequently do not exist or are not in writing or are drawn up as needed. Internal controls covering employee expense accounts are often minimal. In contrast, larger, mature companies are often more highly structured, with well-defined internal controls, compensation structures, benefits packages, and employment policies all in place because the firms have grown too large and complex to function in an orderly manner without them. Employees usually have clearly defined job descriptions and career paths. Decision making, whether decentralized at the operating unit level or centralized within a corporate office, has a well-defined process. It may be ponderous, requiring consensus within a large management bureaucracy.

\textsuperscript{20} Kennedy and Moore (2003) argued that the most important source of communication of cultural biases in an organization is the individual behavior of others, especially those with the power to reward appropriate and to punish inappropriate behavior.

\textsuperscript{21} Maguire and Phillips (2008).
Cultural differences may be exacerbated when firms are combined from different or even across segments within the same industry. When Travelers merged with Citicorp, the huge differences between investment banking salaries and those in insurance fueled resentment in some parts of the combined company.

After senior management reviews the information in the cultural profile, it must decide which characteristics of both cultures to emphasize in the new culture. The most realistic expectation is that employees in the new company can be encouraged to adopt a shared vision, a set of core values, and behaviors deemed important by senior management. Anything more is probably wishful thinking: a company’s culture evolves over a long period. However, getting to the point at which employees wholly embrace management’s desired culture may take years at best or may never be achieved.

Overcoming Cultural Differences

Sharing common goals, standards, services, and space can be a highly effective and practical way to integrate disparate cultures.\(^{22}\) Common goals drive different units to cooperate. For example, at the functional level, setting exact timetables and processes for new product development can drive different operating units to collaborate as project teams strive to introduce the product by the target date. At the corporate level, incentive plans spanning many years can focus all operating units to pursue the same goals. Although it is helpful in the integration process to have shared or common goals, individuals must still have specific goals to minimize the tendency of some to underperform while benefiting from the collective performance of others.

Shared standards or practices enable one unit or function to adopt the “best practices” found in another. Standards include operating procedures, technological specifications, ethical values, internal controls, employee performance measures, and comparable reward systems throughout the combined companies.

Some functional services can be centralized and shared by multiple departments or operating units. Commonly centralized services include accounting, legal, public relations, internal audit, and information technology. The most common way to share services is to use a common staff. Alternatively, a firm can create a support services unit and allow operating units to purchase services from it or to buy similar services outside the company.

\(^{22}\) Malekzadeh and Nahavandi (1990).
Isolating target company employees in a separate building or even a floor of the same building will impair the integration process. Mixing offices or even locating acquired company employees in space adjacent to the parent’s offices is a highly desirable way to improve communication and idea sharing. Common laboratories, computer rooms, libraries, and lunchrooms also facilitate communication and cooperation.23

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Successfully integrated M&As are those that demonstrate leadership by candidly and continuously communicating a clear vision, a set of values, and clear priorities to all employees. Successful integration efforts are those that are well planned, that appoint an integration manager and a team with clearly defined lines of authority, and that make the tough decisions early in the process, whether they are about organizational structure, reporting relationships, spans of control, personnel selection, roles and responsibilities, or workforce reduction. The focus must be on those issues with the greatest near-term impact.

A Case in Point: The Challenges of Integrating Steel Giants Arcelor and Mittal24

You read in Chapter 3 of the June 2006 merger of Arcelor and Mittal that created the world’s largest steel company, ArcelorMittal—a behemoth that accounts for about 10 percent of global output, has 320,000 employees in 60 countries, and had 2007 revenue of $105 billion. The focus here is the formation of the integration team, the importance of communications, and the realization of anticipated synergies.

23 Still, the challenges are enormous in companies with disparate cultures. In early 2006, Jeffrey Bewkes, the president of Time Warner, stopped requiring corporate units to cooperate. This policy change was a complete turnaround from the philosophy espoused following the firm’s 2001 merger with AOL. Then, executives promised to create a well-oiled vertically integrated profit generator. Books and magazines and other forms of content would feed the television, movie, and Internet operations. The 2006 change encouraged managers to cooperate only if they could not make more money on the outside. Other media companies such as Viacom and Liberty Media have broken themselves up because their efforts to achieve corporate-wide synergies with disparate media businesses proved unsuccessful.

24 This case relies on information provided in an interview with Jérôme Granboulan (formerly of Arcelor) and William A. Scotting (formerly of Mittal), the two executives charged with directing the postmerger integration effort, and is adapted from De M edt and Van Hoey (2008).
The two firms’ downstream (raw material) and upstream (distribution) operations proved highly complementary, with Mittal owning much of its iron ore and coal reserves and Arcelor having extensive distribution and service center operations. As in most mergers, ArcelorMittal faced the challenge of integrating management teams; sales, marketing, and product functions; production facilities; and purchasing operations. In this, unlike many mergers involving direct competitors, a relatively small portion of cost savings would come from eliminating duplicate functions and operations.

The goal of the merger was to combine what were viewed as entities having highly complementary assets and skills—quite different from how Mittal had grown through acquisitions of turnaround targets focused on cost and productivity improvements. The merged firm’s top management set three driving objectives before undertaking the postmerger integration effort: achieve rapid integration, manage daily operations effectively, and accelerate revenue and profit growth (viewed as the primary motivation for the merger). The formal phase of the integration effort was to be completed in six months, which made it crucial to agree on the role of the management integration team, key aspects of the integration process such as how decisions would be made, and the roles and responsibilities of team members. Activities were undertaken in parallel rather than sequentially.

Teams comprised employees from both firms, with task force leaders coming from the business units (e.g., commercial integration issues were resolved by the commercial business units). Teams were then asked to propose a draft organization to the MIT, including the profiles of the people who were to become senior managers. Once selected, these senior managers would build their own teams to identify synergies and create action plans for realizing the synergies. Teams were formed before the organization was announced, and implementation of certain actions began before detailed plans had been developed fully. Progress to plan was monitored on a weekly basis, enabling the MIT to identify obstacles facing the 25 decentralized task forces and, when necessary, to resolve issues.

Considerable effort was spent in getting line managers involved in the planning process and selling the merger to their respective operating teams. Initial communication efforts included the launch of a top-management “road show.” The new company also established a website and introduced Web TV. Senior executives gave two-to-three minute interviews on various topics; anyone with a PC could watch.

To address the high level of employee uncertainty that resulted from the merger, managers were given a well-structured message about the significance of the merger and the direction of the new company that they could then transmit to employees. The new brand, ArcelorMittal, was launched at a spring 2007 meeting attended by 500 of the firm’s top managers, marking the end of the formal integration process.
ArcelorMittal’s management used the merger as an opportunity to conduct interviews and surveys with employees to gain an understanding of their views about the two companies. Employees were asked about the combined firms’ strengths and weaknesses and how the new firm should present itself to its various stakeholder groups. This process resulted in a complete rebranding of the combined firms.

All communication of information disseminated throughout the organization was focused rather than general. External communication was conducted in several ways. Immediately following closing, senior managers traveled to all the major cities and sites of operations to talk to local managers and employees. Typically, media interviews were also conducted during these visits, which gave ArcelorMittal opportunities to convey its message to the communities. In March 2007, the new firm held a media day in Brussels, with presentations on the merger status. Journalists were invited to go to the different businesses and review the progress.

Within the first three months following closing, customers were informed about the advantages of the merger for them, such as enhanced R&D capabilities and wider global coverage. The sales forces of the two organizations were charged with the task of creating a single “face” to the market.

With respect to operational and functional integration, ArcelorMittal management set a $1.6 billion target for annual cost savings. The task forces were charged with validating this number from the bottom up and then telling the MIT how the synergies would be achieved. As the merger progressed, it was necessary to get the business units to assume ownership of the process to formulate the initiatives, timetables, and key performance indicators that could be used to track performance against objectives. In some cases, synergy potential was larger or smaller than anticipated. The expectation was that the synergy could be realized by mid-2009.

Integration was deemed complete when the new organization, the brand, the “one face to the customer” requirement, and the synergies were finalized. This occurred within eight months of the closing, though cultural differences between employees of both firms continue. The integration objectives were included in the 2007 annual budget plan. As of the end of 2007, the combined firms were on track to realize their goal with annualized cost savings running $1.4 billion.

**Things to Think About**

1. Why is it important to establish both top-down and bottom-up estimates of synergy?

2. How did ArcelorMittal attempt to bridge cultural differences during the integration? Be specific.

3. Why are communication plans so important? What methods did ArcelorMittal employ to achieve these objectives? Be specific.
4. The formal phase of the postmerger integration period was to be completed within six months. Why do you believe that ArcelorMittal’s management was eager to integrate the two businesses so rapidly? Be specific. What integration activities were to extend beyond the proposed six-month integration period?

Answers can be found at: www.elsevierdirect.com/companion.jsp?ISBN=9780123749482
Abnormal return The return to shareholders due to nonrecurring events that differs from what would have been predicted by the market. It is the return due to an event such as a merger or acquisition.

Acquirer; acquiring company A firm that attempts to acquire a controlling interest in another company.

Acquisition The purchase by one company of a controlling ownership interest in another firm, a legal subsidiary of another firm, or selected assets of another firm.

Acquisition premium See purchase premium.

Acquisition vehicle The legal structure used to acquire another company.

Advance notice provision A condition that requires announcement of shareholder proposals well in advance of the actual vote.

Affirmative covenant A portion of a loan agreement that specifies the actions the borrowing firm agrees to take during the term of the loan.

Agency problem The conflict of interest between a firm’s incumbent managers and shareholders.

Antigreenmail provisions Amendments to corporate charters restricting a firm’s ability to repurchase shares from specific shareholders at a premium.

Antitrust laws Federal laws prohibiting individual corporations from assuming too much market power.

Appraisal rights Rights to seek “fair value” for their shares in court given to target company shareholders who choose not to tender shares in the first or second tier of a tender offer.

Arbitrageurs (“arbs”) In the context of M&As, speculators who attempt to profit from the difference between the bid price and the target firm’s current share price.

Articles of incorporation A document filed with a state government by the founders of a corporation.

Back-end merger The merger following either a single or two-tier tender offer, consisting of either a long form or short form merger, with the latter not requiring a target firm shareholder vote.

Balance sheet assumptions Assumptions about growth in major balance sheet components.

Bear hug A takeover tactic involving the mailing of a letter containing an acquisition proposal to the board of directors of a target company without prior warning, and demanding a rapid decision.

Bidder See acquirer.

Breakup fee A fee that would be paid to the potential acquirer if the target firm decides to accept an alternative bid.

Bridge financing Temporary, unsecured, short-term loans provided by investment banks to pay all or a portion of the purchase price and meet immediate working capital requirements until permanent or long-term financing is found.

Business alliance A generic term referring to all forms of business combinations other than mergers and acquisitions.

Business-level strategies Strategies pertaining to a specific operating unit or product line within a firm.
Business plan A comprehensive analysis of all aspects of a business resulting in a vision for the firm and a strategy for achieving that vision.

Business strategy That portion of a business plan detailing the way a firm intends to achieve its vision.

Buyout Change in controlling interest in a corporation.

Certificate of incorporation A document received from the state after the articles of incorporation have been approved.

Classified board election An antitakeover defense involving the separation of a firm’s board into several classes, only one of which is up for election at any one time. Also called a staggered board election.

Closing The phase of the acquisition process in which ownership is transferred from the target to the acquiring firm in exchange for some agreed-upon consideration following the receipt of all necessary shareholder, regulatory, and third-party approvals.

Confidentiality agreement A mutually binding accord defining how information exchanged among the parties may be used and the circumstances under which the discussions may be made public. Also known as a nondisclosure agreement.

Conglomerate discount The share prices of conglomerates often trade at a discount from focused firms or from their value if they were broken up and sold in pieces.

Conglomerate Firms that operate in a number of largely unrelated industries.

Conglomerate merger Transaction in which the acquiring company purchases firms in largely unrelated industries.

Consent solicitation A process enabling dissident shareholders in certain states to obtain shareholder support for their proposals simply by obtaining their written consent.

Consolidation A business combination involving two or more companies joining to form a new company, in which none of the combining firms survive.

Contingency plans Actions that are undertaken if a firm’s current business strategy appears not to be working.

Contingent value rights In M&A transactions, commitments by the acquirer to pay additional cash or securities to the seller if the share price of the issuing company falls below a specified level at some future date.

Control premium The excess over the target’s current share price the acquirer is willing to pay to gain a controlling interest. A pure control premium would be one in which the anticipated synergies are small, and the perceived value of the purchase is in gaining control to direct the activities of the target firm.

Corporate bylaws Rules governing the internal management of a corporation, which are determined by the corporation’s founders.

Corporate charter A state license defining the powers of a firm and the rights and responsibilities of its shareholders, board of directors, and managers. The charter consists of articles of incorporation and a certificate of incorporation.

Corporate culture The common set of values, traditions, and beliefs that influence behavior of a firm’s employees.

Corporate-level strategies Strategies that cut across business unit organizational lines and that entail decisions such as financing the growth of certain businesses, operating others to generate cash, divesting some units, or pursuing diversification.

Corporate governance The systems and controls in place to protect the rights of corporate stakeholders.

Corporate restructuring Actions taken to expand or contract a firm’s basic operations or fundamentally change its asset or financial structure.
Cost leadership A strategy designed to make a firm the cost leader in its market by constructing efficient production facilities, tightly controlling overhead expense, and eliminating marginally profitable customer accounts.

Covenants Promises made by a borrower that certain acts will be performed and others will be avoided.

Cram down A legal reorganization occurring whenever one or more classes of creditors or shareholders approve, even though others may not.

Creeping takeover strategy Takeover in which bidders acquire target voting shares in relatively small amounts until they have achieved effective control of the target.

Cross-default provisions Clauses in loan agreements that allow a lender to collect its loan immediately if the borrower is in default on a loan to another lender.

Crown jewels lockup An arrangement in which the initial bidder obtains an option to buy important strategic assets of a target, if the target chooses to sell to another party.

Cumulative voting rights In an election for a board of directors, each shareholder is entitled to as many votes as shall equal the number of shares the shareholder owns multiplied by the number of directors to be elected. Furthermore, the shareholder may cast all of these votes for a single candidate or for any two or more of them.

Deal breakers Issues that a party to the negotiation cannot concede without making the deal unacceptable.

Deal-structuring process A process focused on satisfying as many of the primary objectives of the parties involved and determining how risk will be shared.

Debentures Long-term debt issues not secured by specific assets, and hence their quality depends on the general creditworthiness of the issuing company.

Defensive acquisition An acquisition made to reduce a firm’s cash position or borrowing capacity.

Differentiation A strategy to create a perception by customers that a product or service offered is slightly different from other product or service offerings in the marketplace.

Distributed payments Purchase price payments contingent on the target satisfying an agreed-upon milestone, such as reaching a profit or cash flow target, successfully launching a new product, obtaining regulatory or patent approval, and so on.

Diversification A strategy of buying firms outside the company’s primary line of business.

Diversification discount See conglomerate discount.

Diversification strategy A strategy at the corporate level to enter new businesses, which may be related or completely unrelated to a corporation’s existing business portfolio.

Divestiture The sale of all or substantially all of a company or product line to another party for cash or securities.

Divisional organization An organizational structure in which groups of products are combined into independent divisions or “strategic business units.”

Dual class recapitalization A takeover defense in which a firm issues multiple classes of stock in which one class has voting rights that are 10 to 100 times those of another class. Such stock is also called supervoting stock.

Due diligence The process by which the acquirer seeks to determine the accuracy of the target’s financial statements, evaluate the firm’s operations, validate valuation assumptions, determine fatal flaws, and identify sources and destroyers of value.

Earnouts Payments to a seller based on the acquired business achieving certain profit or revenue targets.

Economies of scale The spreading of fixed costs over increasing production levels.
Economies of scope  The use of a specific set of skills or an asset currently used to produce a specific product to produce related products.

Employee stock ownership plan (ESOP)  A trust fund or plan that invests in the securities of the firm sponsoring the plan on behalf of the firm’s employees. Such plans are generally employee defined contribution retirement plans.

Equity carve-out  A transaction in which the parent firm issues a portion of its stock or that of a subsidiary to the public.

Escape clause  A feature common to poison pills enabling the board of the issuing company to redeem the pill through a nominal payment to the shareholders.

Exchange offer  A tender offer involving a share-for-share exchange.

Experience curve  A concept which postulates that as the cumulative historical volume of a firm’s output increases, cost per unit of output decreases.

External analysis  The development of an in-depth understanding of a business’s customers and their needs, underlying market dynamics or factors determining profitability, and emerging trends that affect customer needs and market dynamics.

Fair price provisions  A takeover defense requiring that all target shareholders of a successful tender offer receive the same price as those tendering their shares.

Financial buyer  Acquirer who focuses on relatively short-to-intermediate financial returns.

Financial restructuring  Actions taken by a firm to change its total debt and equity structure.

Financial risk  A buyer’s willingness and ability to leverage a transaction, as well as the willingness of shareholders to accept near-term earnings per share dilution.

Financial synergy  The reduction in the cost of capital as a result of more stable cash flows, financial economies of scale, or a better matching of investment opportunities with available funds.

Flip-in poison pill  A shareholders’ rights plan in which the shareholders of the target firm can acquire stock in the target firm at a substantial discount.

Flip-over poison pill  A shareholders’ rights plan in which target firm shareholders may convert such rights to acquire stock of the surviving company at a substantial discount.

Float  The amount of stock that can be most easily purchased by the acquirer.

For cause provisions  Clauses that specify the conditions for removing a member of the board of directors.

Focus strategy  A strategy in which firms tend to concentrate their efforts by selling a few products or services to a single market and compete primarily on the basis of understanding their customers’ needs better than the competition.

Form of acquisition  An acquisition that reflects what is being acquired (i.e., stock or assets).

Form of payment  A payment that may consist of cash, common stock, debt, or some combination. Some portion of the payment may be deferred or dependent on the future performance of the acquired entity.

Franchise  A privilege given to a dealer by a manufacturer or franchise service organization to sell the franchisor’s product or service in a given area.

Freeze-out  A situation in which an acquirer decides not to acquire 100 percent of the target’s stock but the remaining shareholders become dependent on the decisions made by the majority shareholders.

Friendly takeover  A takeover situation in which the target’s board and management are receptive to the idea and recommend shareholder approval.
Functional organization An organization in which employees are assigned to specific groups or departments such as accounting, engineering, marketing, sales, distribution, customer service, manufacturing, or maintenance.

Functional strategies Policies that describe in detail how each major function (see *functional organization*) within the firm will support the business strategy.

Golden parachute An employee severance arrangement triggered whenever a change in control takes place.

Going private The purchase of the publicly traded shares of a firm by a group of investors.

Go-shop provision A clause that allows a seller to continue to solicit other bidders for a specific period after an agreement has been signed but before closing. However, if the seller accepts another bid, it must pay a breakup fee to the bidder with whom they had a signed agreement.

Greenmail The practice of a firm buying back its shares at a premium from an investor threatening a takeover.

Growth strategy A business strategy that concentrates on growing a firm’s revenues, profit, and cash flow.

Hedge fund Private investment limited partnerships (for U.S. investors) or an off-shore investment corporation (for non-U.S. or tax-exempt investors) in which the general partner has made a substantial personal investment. Hedge fund bylaws generally allow the fund to engage in a wide variety of investing activities.

Highly leveraged transactions Those transactions involving a substantial amount of debt relative to the amount of equity invested.

Horizontal merger A combination of two firms within the same industry.

Hostile takeover A takeover that occurs when the initial bid was unsolicited, the target was not seeking a merger at the time of the approach, the approach was contested by the target’s management, and control changed hands.

Hostile tender offer A tender offer that is unwanted by the target’s board.

Hubris An explanation for takeovers that attributes a tendency to overpay to excessive optimism about the value of a deal’s potential synergy or excessive confidence in management’s ability to manage the acquisition.

Implementation strategy The way in which a firm chooses to execute its business strategy.

Income statement assumptions Assumptions related to projected growth in revenue, the implicit market share, and the major components of cost.

Incentive systems Bonus, profit sharing, or other performance-based payments made to motivate both acquirer and target company employees to work to implement the business strategy for the combined firms.

Industry A collection of markets.

Internal analysis The determination of a firm’s strengths and weaknesses as compared to its competitors.

Initial public offering (IPO) The first offering to the public of common stock of a formerly privately held firm.

Indemnification A common contractual clause requiring a seller to indemnify or absolve the buyer of liability in the event of misrepresentations or breaches of warranties or covenants. Similarly, the buyer usually agrees to indemnify the seller. In effect, it is the reimbursement of the other party for a loss for which it was not responsible.
In play A situation in which a firm is believed by investors to be vulnerable to or willing to undergo a takeover due to a bid or rumors of a bid.

**Investment banks** Advisors who offer strategic and tactical advice and acquisition opportunities; screen potential buyers and sellers; make initial contact with a seller or buyer; and provide negotiation support, valuation, and deal-structuring advice.

**Joint venture** A cooperative business relationship formed by two or more separate entities to achieve common strategic objectives.

**Junk bond** High-yield bonds that credit-rating agencies have deemed either to be below investment grade or that they have not rated at all. Also called high-yield debt.

**Legal form of the selling entity** A term that refers to whether the seller is a C or subchapter S corporation, a limited liability company, or a partnership.

**Letter of intent** A preliminary agreement between two companies intending to merge that stipulates major areas of agreement between the parties, as well as their rights and limitations.

**Leveraged buyout** A transaction involving the purchase of a company financed primarily by debt.

**Leveraged loan** Unrated or noninvestment-grade bank loan whose interest rate is equal to or greater than the London Interbank Rate (LIBOR) plus 150 basis points (1.5 percentage points).

**Leveraged recapitalization** A situation in which a firm assumes substantial amounts of new debt, often used to buy back stock, finance a dividend to shareholders, or make it less attractive to a potential bidder.

**License** The authority to grant to others rights to use specific proprietary assets.

**Liquidating dividend** The dividend paid to shareholders from the proceeds of a liquidation of a company, distributed from proceeds remaining after outstanding obligations have been paid to creditors.

**Loan agreement** An agreement that stipulates the terms and conditions under which a lender will loan a firm funds.

**Management buyout** A leveraged buyout in which managers of a firm to be taken private are also equity investors in the transaction.

**Management entrenchment theory** A theory that managers use a variety of takeover defenses to ensure their longevity with a firm.

**Management integration team** A team of senior managers from two merged organizations charged with delivering on sales and operating synergies identified during the preclosing due diligence.

**Managerialism theory** A theory espousing that managers acquire companies to increase the acquirer’s size and their own remuneration.

**Market** A collection of customers, whether individual consumers or other firms, exhibiting common characteristics and needs.

**Market assumptions** Assumptions about the growth rate of unit volume and product price per unit.

**Market power** A situation in which the merger of two firms will enable the resulting combination to profitably maintain prices above competitive levels for a significant period.

**Merger** A combination of two or more firms in which all but one legally cease to exist.

**Merger/acquisition plan** A specific type of implementation strategy that describes in detail the motivation for the acquisition and how and when it will be achieved.

**Merger of equals** A merger framework usually applied whenever the merger participants are comparable in size, competitive position, profitability, and market capitalization.
**Mezzanine financing** Unsecured debt that lies between senior debt and the equity layers.

**Minority investment** A less-than-controlling interest in another firm.

**Monitoring systems** Systems implemented to track the actual performance of combined firms against a business plan.

**Negative covenant** A loan agreement that restricts the actions of a borrower.

**No-shop agreement** An agreement that prohibits a takeover target from seeking other bids or making public information that is not currently readily available while in discussions with a potential acquirer.

**Open-market purchase** The act of a corporation buying its shares in the open market at the prevailing price as any other investor, as opposed to a tender offer for shares or a repurchase resulting from negotiation such as with an unwanted investor.

**Operational restructuring** The outright or partial sale of companies or product lines, or downsizing by closing unprofitable or nonstrategic facilities.

**Operating risk** The ability of a buyer to manage an acquired company.

**Operating synergy** A concept that consists of both economies of scale and scope.

**Overpayment risk** The dilution of earnings per share or a reduction in the earnings growth rate resulting from paying significantly more than the economic value of an acquired company.

**Permanent financing** Financing usually consisting of long-term unsecured debt.

**Poison pill** A new class of securities issued as a dividend by a company to its shareholders, giving shareholders the right to acquire more shares at a discount. These securities have no value unless an investor acquires a specific percentage of the target firm’s voting stock.

**Private solicitation** The behavior of a firm seeking potential buyers on its own or hiring an investment banker to identify potential buyers.

**Product or service organization** An organization in which functional specialists are grouped by product line or service offering.

**Product life cycle** A pattern characterizing a product’s evolution in four stages: embryonic, growth, maturity, and decline.

**Promissory note** A legal document that commits a borrower to repay a loan, even if the assets, when liquidated, do not fully cover the unpaid balance.

**Proxy contest** An attempt by dissident shareholders to obtain representation on the board of directors or to change a firm’s bylaws.

**Proxy statement** According to SEC regulations, target shareholders must receive materials that include the date of the shareholders’ meeting at which approval of the transaction is to be solicited, details of the merger agreement, company backgrounds, reasons for the proposed merger, and opinions of legal and financial advisors. Proxy statement materials may also be required for other governance-related issues, such as the election board of members.

**Public solicitation** A firm’s public announcement that it is putting itself, a subsidiary, or a product line up for sale.

**Purchase premium** The excess of an offer price over a target’s current share price, which reflects both the value of expected synergies and the amount necessary to obtain control.

**Pure control premium** The value an acquirer believes can be created by replacing incompetent management or by changing the strategic direction of a firm.

**Q-ratio** The ratio of the market value of a firm to the cost of replacing its assets.

**Reincorporation** The act of a firm changing its state of incorporation to one in which the laws are more favorable for implementing takeover defenses.
Retention bonus  Incentives granted to key employees of a target firm if they remain with the combined companies for a specific period following completion of the transaction.

Reverse breakup fee  A fee paid to a target firm in the event the bidder wants to withdraw from a signed contract.

Secured debt  Long-term debt issues, typically referred to as mortgage bonds or equipment trust certificates.

Security agreement  A legal document stipulating which of a borrower’s assets will be pledged to secure a loan.

Self-tender offer  A tender offer used when a firm seeks to repurchase its stock from its shareholders.

Seller financing  A loan provided by the seller of a property to the buyer to cover all or part of the sale price. Also known as owner carry back or owner financing.

Shareholder interests theory  The presumption that management resistance to proposed takeovers is a good bargaining strategy to increase the purchase price for the benefit of the target firm shareholders.

Shark repellents  Specific types of takeover defenses that can be adopted by amending either a corporate charter or its bylaws.

Squeeze-out  See freeze-out.

Spinoff  A transaction in which a parent creates a new legal subsidiary and distributes shares it owns in the subsidiary to its current shareholders as a stock dividend.

Staged payouts  See distributed payments.

Staggered board election  A takeover defense involving the division of a firm’s directors into a number of different classes, with no two classes up for reelection at the same time. Also called a classified board election.

Stakeholders  Groups having interests in a firm such as customers, shareholders, employees, suppliers, regulators, and communities.

Standstill agreement  A contractual arrangement in which the acquirer agrees not to make any further investments in a target’s stock for a stipulated period.

Statutory consolidation  Two or more companies joining to form a new company, but technically not a merger because all legal entities that are consolidated are dissolved during the formation of the new company, which usually has a new name.

Statutory merger  The combination of acquiring and target firms, in which one firm ceases to exist, in accordance with the statutes of the state in which the combined businesses will be incorporated.

Stock lockup  An option granted to a bidder to buy a target firm’s stock at that bidder’s initial offer that is triggered whenever a competing bid (usually higher) is accepted by the target firm.

Strategic alliance  An informal cooperative arrangement, such as an agreement to co-develop a technology, product, or process.

Strategic realignment  A theory suggesting that firms use takeovers as a means of rapidly adjusting to changes in their external environment such as deregulation and technological innovation.

Subsidiary merger  A transaction in which the target becomes a subsidiary of the parent.

Success factors  Those strengths or competencies necessary to compete successfully in the firm’s chosen market.
Super-majority rules  A takeover defense requiring a higher level of approval for amending the charter or for certain types of transactions such as a merger or acquisition.

Supervoting stock  A class of voting stock having voting rights many times those of other classes of stock.

SWOT analysis  The external and internal analyses undertaken to determine a business’s strengths, weaknesses, opportunities, and threats.

Syndicate  A large group of investment banks.

Synergy  The notion that the value of combined enterprises will exceed the sum of their individual values.

Synergy assumptions  Assumptions related to the amount and timing of expected synergy.

Takeover  Generic term referring to a change in the controlling ownership interest of a corporation.

Takeover defenses  Protective devices put in place by a firm to frustrate, slow down, or raise the cost of a takeover.

Target; target company  A firm that is being solicited by an acquiring company.

Tax considerations  Structures and strategies determining whether a transaction is taxable or nontaxable to the seller’s shareholders.

Tender offer  The offer to buy shares in another firm, usually for cash, securities, or both.

Term loan  A loan usually having a maturity of 2 to 10 years and typically secured by the asset that is being financed, such as new capital equipment.

Term sheet  A document outlining the primary areas of agreement between buyer and seller, often used as the basis for a more detailed letter of intent.

Termination fee  See breakup fee.

Two-tiered offer  A tender offer in which target shareholders receive an offer for a specific number of shares. Immediately following this offer, the bidder announces its intentions to purchase the remaining shares at a lower price or using something other than cash.

Unfriendly takeover  See hostile takeover.

Valuation assumptions  Assumptions about an acquirer’s target debt-to-equity ratio, discount rates, and growth assumptions.

Vertical merger  A merger in which companies that do not own operations in each major segment of the value chain choose to backward integrate by acquiring a supplier or to forward integrate by acquiring a distributor.

White knight  A potential acquirer that is viewed more favorably by a target firm’s management and board than the initial bidder.

Winner’s curse  The tendency of auction winners to show remorse believing that they may have paid too much.
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