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MGST 451

Corporate Governance and Ethical Decision-Making

Lecture 17 – Winter 2019 L01-L03

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Lecture 17 Agenda

You may want to review chapter 28 of the FNCE317 textbook

1. The market for corporate control
2. Mergers and Acquisitions (M&A)
   - Volumes, type of mergers, and economics
   - Reasons to acquire
   - Management M&A overconfidence biases
3. The Competition Act (Canada)
4. Canadian M&A corporate tax issues
   - Example 28.1 (page 947)

The Market for Corporate Control

Sources of growth (growth is a key component of value creation)

- **Internal growth** (aka organic growth)
  - Fundamental research & development: new technologies;
  - Business expansion: new products, new geographic markets, new customers, etc.;
  - Can be slow + customers might not respond as expected.
- **External growth**: achieving growth by way of acquisition(s)
  - The firm acquires companies or divisions, and ‘integrate’ these acquisitions: get new technologies, new products…;
  - Can be quick, but might overpay and integration might fail;
  - Can be very attractive if a target company is undervalued and a ‘good fit’ (e.g. non-overlapping or complementary).

The Market for Corporate Control

Traditional/historical perspective

- When a healthy firm acquires a failing firm, it is a preferable resolution mechanism in comparison to a bankruptcy.
- If two healthy firms merge, the economic cost of increased concentration and lower competition is a serious concern.

The Market for Corporate Control (Manne 1965)

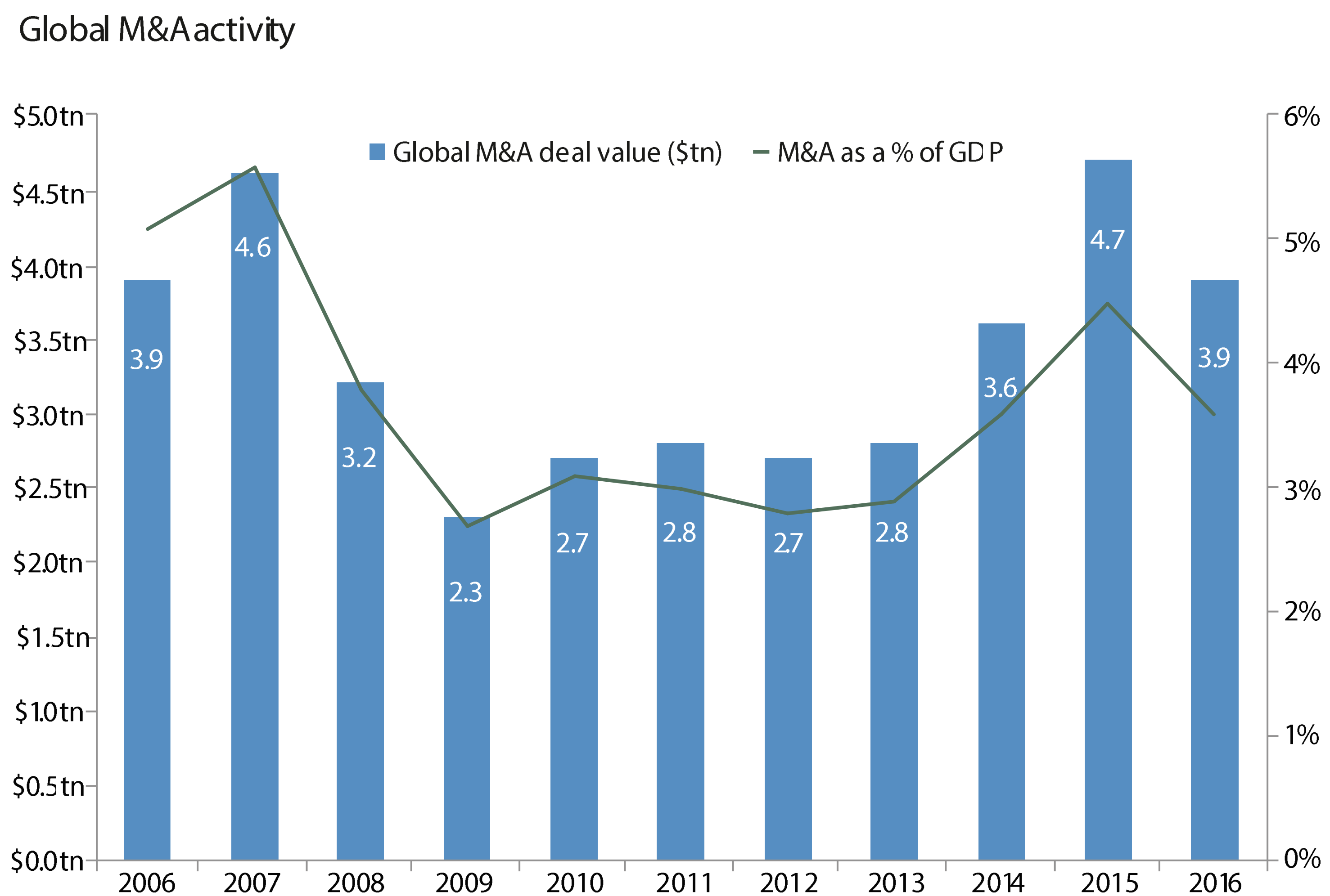
- Control of firm is of value by itself (an asset).
- Market price of firm's equity reflects its managerial efficiency.
- Low share price resulting from inefficient management creates potential capital gain from acquiring control of firm.
- In a way, inefficient executives create a capital gain incentive for outsiders to take them out.

The Market for Corporate Control

Change of control mechanisms

- **Proxy fight**: an outsider tries to convince shareholders (through mailings, telephone calls, meetings with large shareholders, etc.) to vote for its board nominees and obtain control of the firm.
- **Purchase of shares**: 'outright purchase on open market of the requisite percentage of shares' (percentage depends) or a tender offer (purchase from shareholders at certain price).
- **Merger**: control is bought with acquirer own shares or a mix of shares and cash in a tender offer for all target shares at once, (typically lead to a negotiation between the acquirer and the target, and to a vote by shareholders of target).
- The latter two categories are often referred to as a **takeover**.

Volume of M&A Transactions



Sources: J.P. Morgan, Dealogic and IMF GDP forecasts as of January 10, 2017; M&A as a % of GDP is rounded to the nearest decimal

Type of Mergers

Horizontal merger

- The acquirer and the target are in the same industry, sort of 'side by side'

Vertical merger

- The acquirer and the target are in the same industry, but active mostly at different stages of the supply chain.

Conglomerate merger

- The acquirer and the target are in unrelated industries.

Economics of Mergers and Acquisitions

Evidence (M&A is a favorite topic of academic research)

- Acquirers pay large premiums over the market price of target.
- Target's share price increases substantially when offer announced (but less than the premium offered by acquirer).
- Acquirer share price has an about equal probability to go up or down, and on average does not move much.
- About half of acquisitions do not work out as expected.

Implications

- Often an announced M&A transaction is not completed.
- Almost all the value expected to be created by a given M&A transaction accrues to the shareholders of the target.
- Growth, organic or by acquisition, is not easy to achieve.

Reasons to Acquire

- Synergies between acquirer and target
  - Cost reduction (relatively easy to achieve, but beware);
  - Revenue enhancements (difficult to achieve).
- Economies of scale
- Economies of scope
- Vertical integration
- Expertise
- Monopoly gains
- Efficiency gains
- Operating losses
- Diversification
- Earnings growth

Reasons to Acquire

What is a synergy?

- A synergy can be viewed as the value added by the system as a whole, beyond what is contributed by its parts. Synergies are created by the relationships among the parts of the system, how the parts are interconnected and work together.
- In a business context, synergies are often referred to as the benefits expected from a firm merging with or acquiring another firm (i.e. the resulting whole is expected to be more than the sum of the pre-existing parts).
- The above synergies are assumed to be positive, but negative synergies may also arise. E.g. if two adverstising agencies merge, some clients might have to be let go to avoid conflict of interest (working on both GM and Ford at the same time?).

Reasons to Acquire

Cost reductions

- The combined entity needs less resources than the merged entities on their own (e.g. combine the headquarters).

Revenue enhancements

- The combined entity is able to generate more revenue than the merged entities on their own (e.g. sales force has more products to sell to a larger customer base).

Economies of scale

- The combined entity is able to produce higher volumes at a lower per unit cost (reverse: dis-economies of scale).

Economies of scope

- Production / selling of various products using same resources.

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Reasons to Acquire

Vertical integration

- Allows acquirer direct control either upstream (inputs) from acquiring suppliers or downstream (output) acquiring client.

Expertise

- You can develop expertise in-house, but it might takes too long, or you can hire key personnel one at a time, but they may come with non-compete. Acquiring a firm, assuming you can retain personnel, get you a whole team and patents.

Monopoly gains

- Merging two competitors reduces competition which likely lead to increased profits (but for all industry players at the sole cost of the acquirer shareholders + subject to antitrust).

Reasons to Acquire

Efficiency gains (easy to identify and difficult to achieve/deliver)

- Management of acquirer has capability and plan to manage the merged entity better than management of target.

Operating losses (carryback and carryforward tax shields)

- The merged entity has better ability to use losses of target.
- CRA or IRS can disallow if only for tax planning purposes.

Diversification

- Risk reduction: a merged entity might be less risky (but shareholders are well diversified and prefer ‘pure plays’).
- Debt capacity and borrowing costs: a merged entity might have lower financial distress costs and can increase leverage.
- Liquidity: shareholders of target cash out and can diversify.

Reasons to Acquire : Examples 28.2 and 28.3

Earnings growth: Potential to get a higher EPS for the merged entity (i.e. called EPS accretive, reverse is EPS dilutive).

	EPS	Nb. of Shares	Market price	Valuation
ABC Corp	\$5/share	1 million	\$60/share	\$60 million
XYZ Corp	\$5/share	1 million	\$100/share	\$100 million

- XYZ acquires ABC issuing 600,000 shares (no value created).
- Value of XYZ: 1.6 million shares x \$100/share = \$160 million.
- EPS of merged entity increase to \$6.25 per share

$$EPS = \frac{\$10\ million}{1.6\ million\ shares} = \$6.25/share$$

- P/E ratio decreases from 20 to 16 (more EPS from low growth)

$$P/E = \frac{\$100/share}{\$5/share} = 20 \rightarrow P/E = \frac{\$100/share}{\$6.25/share} = 16$$

Management M&A Overconfidence Biases

Synergy bias

- Executives consciously (or unconsciously) underestimate the costs and overestimate the benefits to justify going ahead with the acquisition whether or not its benefits will outweigh the costs.

Parenting bias

- Executives compel business units to cooperate, this often encourages executives to intervene too much or too often - which could lead to more harm than good.

Skills bias

- Managers assume the know-how required for the synergies to materialize exists within the organization. Often this is not the case.

Upside bias

- Executives concentrating on the benefits of the synergies and ignore or overlook the likelihood of negative consequences.

The Competition Act (Canada)

- See http://www.mccarthy.ca/pubs/antitrus_overview.pdf
- The Act allows the Competition Tribunal to reviews mergers and requires pre-merger notification.
- Merger: “the acquisition of control over, or a significant interest in, the whole or part of a business.”
- Mergers that are deemed to be anti-competitive can be challenged (i.e. denied or approved with conditions).
- A monopoly is not illegal but abuse of a dominant position by way of anti-competitive acts might lead the Tribunal to act.
- Dominance when market share above 35% (60% jointly).
- Anti-competitive acts: selling at lower than cost, acquisition of scarce resources, etc. with a predatory or exclusionary intent.

Canadian M&A Corporate Tax Issues

Intra-Group Loss Planning in Canada

- See https://www.policyschool.ca/wp-content/uploads/2016/03/corporate-group-taxation.pdf
- Contrary to the U.S. and several other OECD countries, joint tax filings for corporate groups is not allowed in Canada.
- There is no formal mechanism for the recognition of losses of one entity of a group against the profit of a second entity.
- So, corporate groups resort to ‘informal self-help loss trading’
  - E.g. use intercompany debt to move a loss by creating an interest expense in one entity and a revenue in another.
- It complicates tax matters of corporate groups in Canada, and creates tax uncertainty as well as additional expenses.

Canadian M&A Corporate Tax Issues: Example 28.1

	Outcome 1 (50% pb.)		Outcome 2 (50% pb.)		Expected (average)	
	Profit	Taxes	Profit	Taxes	Profit	Taxes
Ying Corp	$50 million	$17 million	-$20 million	-	$15 million	$8.5 million
Yang Corp	-$20 million	-	$50 million	$17 million	$15 million	$8.5 million
Merged	$30 million	$10 million	$30 million	$10 million	$30 million	$10 million

- Ying and Yang have same profit (but negatively correlated), a tax rate of 34%, and expected net income of $6.5 million each.
- If merged, same total pre-tax profit, but lower taxes and net income increases from $13 million to $19.8 million.
- However, firms can carryback operating losses 3 years in Canada (2 in the US) and carryforward same up to 20 years, delivering tax benefits of conglomeration to small firms.

Further Example: Problem 9 (page 969)

	EPS	Nb. of Shares	Market price	Valuation	P/E
Acquirer	$4/share	1 million	$40/share	$40 million	10
Target	$2/share	1 million	$25/share	$25 million	12.5

- No value created since no expected synergies.
- No premium paid
  - Acquisition of Target by issuing 625,000 shares of Acquirer
  - EPS of merged entity decrease to $3.69 per share

$$EPS = \frac{\$6\ million}{1.625\ million\ shares} = \$3.69/share$$

  - P/E ratio increases from 10 to 10.83

$$P/E = \frac{\$40/share}{\$4/share} = 10 \rightarrow P/E = \frac{\$40/share}{\$3.69/share} = 10.83$$

- Since the P/E of the target is higher than the P/E of the Acquirer, the merged entity has lower EPS but higher P/E.
- The shareholders of the Acquirer are no better or worse off.

Further Example: Problem 9 (page 969)

	EPS	Nb. of Shares	Market price	Valuation	P/E
Acquirer	$4/share	1 million	$40/share	$40 million	10
Target	$2/share	1 million	$25/share	$25 million	12.5

- No value created since no expected synergies.
- Premium of 20% paid ($25 million x 1.2 = $30 million)
  - Acquisition of Target by issuing 750,000 shares of Acquirer
  - EPS of merged entity decrease to $3.43 per share

$$EPS = \frac{\$6\ million}{1.75\ million\ shares} = \$3.43/share$$

  - P/E ratio increases from 10 to 11.66

$$P/E = \frac{\$40/share}{\$4/share} = 10 \rightarrow P/E = \frac{\$40/share}{\$3.43/share} = 11.66$$

- Since the P/E of the target is higher than the P/E of the Acquirer, the merged entity has lower EPS but higher P/E.
- Are the shareholders of the Acquirer better or worse off?