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MGST 451

Corporate Governance and Ethical Decision-Making

Lecture 18 – Winter 2019 L01-L03

By Dr. René Wells, CFA

Haskayne School of Business

Lecture 18 Agenda

You may want to review chapter 28 of the FNCE317 textbook

1. The Takeover Process
   - Valuation: how much to offer/pay for the target
   - Tax and Accounting Issues
   - The Offer
   - M&A Arbitrage
   - Board and Shareholder Approval (or Rejection)
2. Takeover Defenses

The Takeover Process: Valuation

Valuation (how much the acquirer shall pay/offer for target)

- The comparable method
  - Constitute a sample of firms comparable to the target firm (i.e. a set of industry peers) and using valuation multiples (e.g. P/E) develop a valuation range for the target.
  - May want to fine-tune the valuation range by including the net present value of the synergies minus the implementation costs.
  - See: https://en.wikipedia.org/wiki/Valuation_using_multiples
- The discounted cash flow method
  - Develop a projection of the cash flows resulting from the transaction (+ changes in capital structure, if any).
  - Value the cash flows using an appropriate discount rate.
- OK if valuation > pre-bid market capitalization + premium.

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Example of the comparable method

Company	Market Cap	Enterprise Value (EV)	Trailing P/E	Forward P/E	Price / Sales	Price / Book	EV / Revenues	EV / EBITDA
The Coca-Cola Company	$197B	$227B	30.71	20.38	6.18	11.58	7.13	21.44
PepsiCo, Inc.	$164B	$185B	13.27	19.62	2.53	11.31	2.87	14.45
Keurig Dr Pepper Inc.	$38B	$53B	51.38	19.45	5.14	1.70	7.13	24.50
Average	$133B	$155B	31.79	19.82	4.62	8.20	5.71	20.13
Monster Beverage Corp.	$33B	$32B	34.22	26.07	8.59	9.07	8.40	23.38
-Trailing Earnings	$0.96B		$30B					
-Forward Earnings	$1.25B			$25B				
- Sales	$3.81B				$18B			
- Book	$3.61B					$30B		
- Revenues	$3.89B						$22B	
- EBITDA	$1.40B							$28B
Average Market Cap	$26B							
Average EV	$25B							

Value as is (comparable or current market price)

+ PV of operational and strategic synergies

+ PV of capital structure and/or tax gains (if any)

- PV of costs to acquire and integrate/absord operations

= Takeover valuation

Tax and Accounting Issues

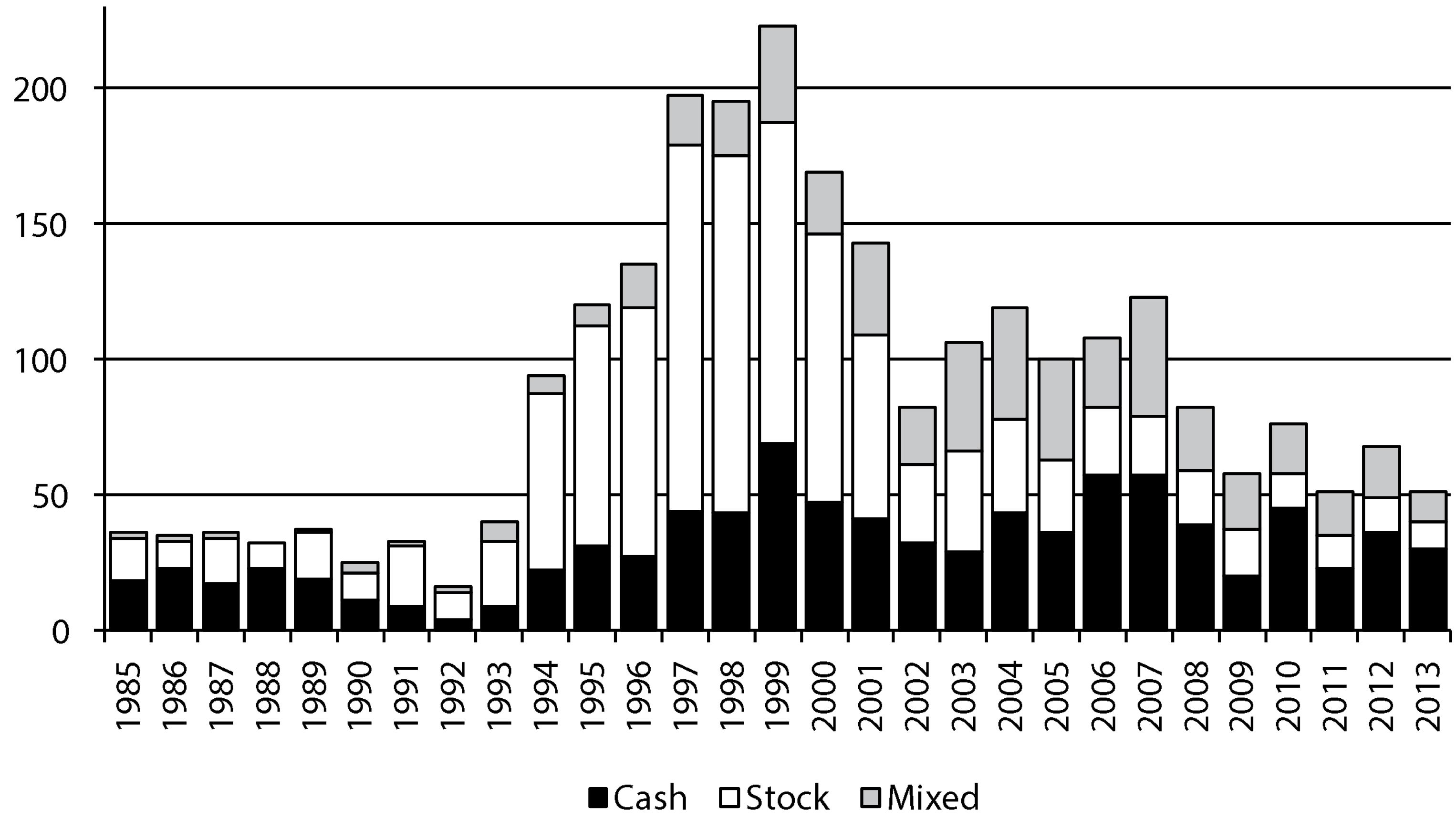
- M&A transactions tend to trigger substantial tax and accounting consequences for both the acquirer and the target, as well as for the shareholders of the target.
- If the acquirer wishes to pay cash, the shareholders of the target might face an immediate tax liability upon receipt of cash for their shares, as opposed to a deferred tax liability if the acquirer pay them with its own newly-issued shares.
- M&A accounting issues are complex, but usually the extent to which the transaction would be EPS accretive or EPS dilutive is estimated. This is explained to shareholders and transactions that are dilutive a little for a short time are viewed as acceptable, but large and permanent EPS dilutions are not.

The Takeover Process: The Offer

The Offer (has to meet whatever securities regulations in force)

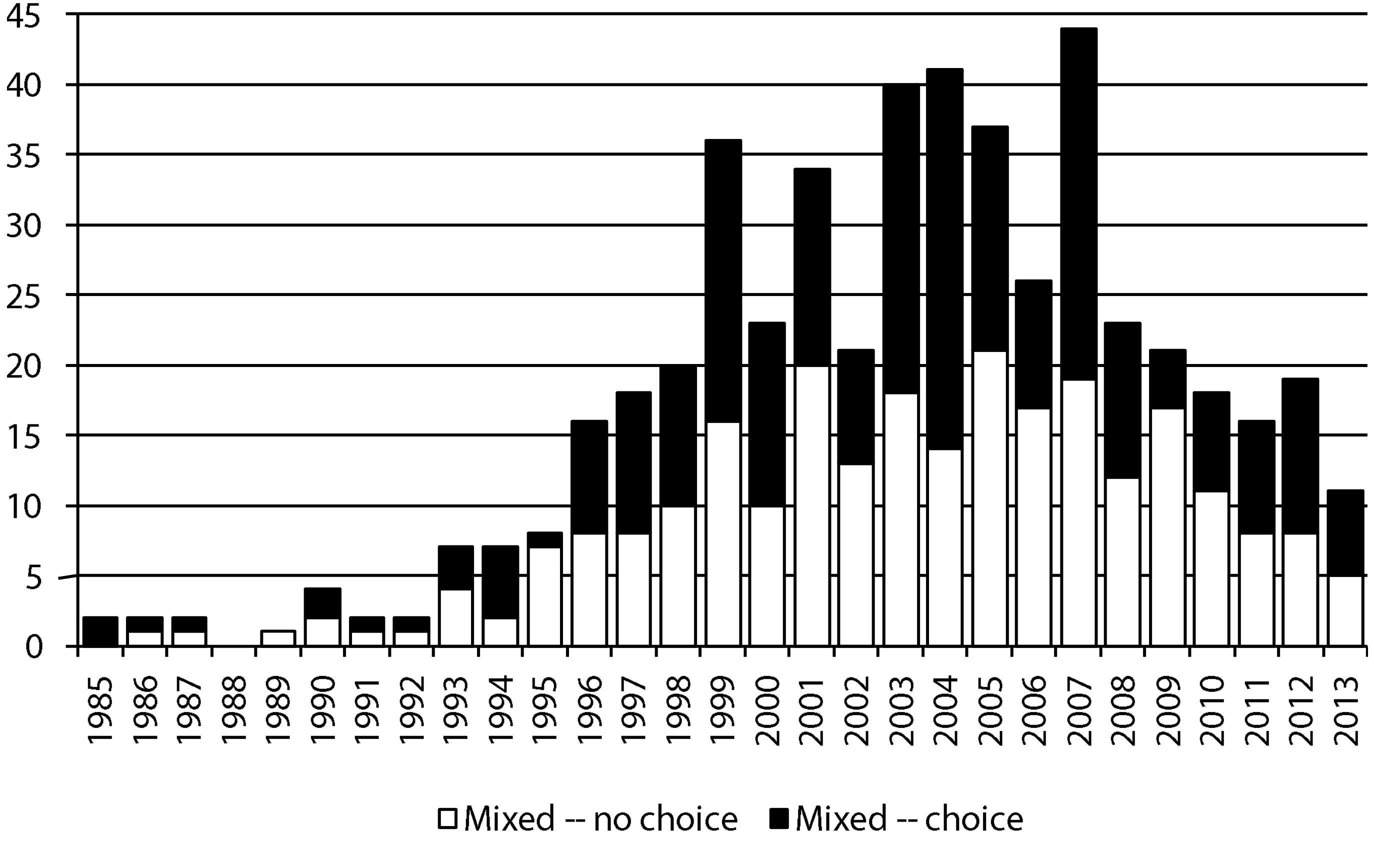
- A public announcement by the acquirer of its offer to purchase shares of the target firm at a certain price.
- A **cash offer** is the per share cash amount offered to the shareholders of the target to tender shares to the acquirer.
- A **stock-swap** offer is when the acquirer wishes to use as medium of payment its own shares as currency; it specifies how many shares of the acquirer are to be delivered for each share of the target firm (aka the ‘exchange ratio’).
- Might offer options between the above two or a combination.
- Need to specify for how long the offer is valid, the minimum number of shares tendered for the offer to be valid, contain the required information disclosures, etc.

US M&A payment method



Source: Boone, Lie, and Liu (2014)

US M&A payment method (mixed with or without choice)



Source: Boone, Lie, and Liu (2014)

The Takeover Process: M&A Arbitrage

M&A Arbitrage (aka risk arbitrage, since not a risk free arbitrage)

- Assume you believe that the transaction will go through.
- A capital gain can be earned by capturing the arbitrage spread (i.e. the difference between the tender price and the actual share price of the target), as this spread eventually varnishes if the takeover actually takes place (i.e. is approved/realized).
- Cash deal: buy shares of the target;
- Share deal: buy shares of the target and short the acquirer.
- M&A arbitrage will result in a capital loss if the takeover fails.
- This is relevant from a corporate governance perspective, since if many such arbitrageurs acquire shares of the target it increases the probability that shareholders of the target will vote in favor or the transaction…

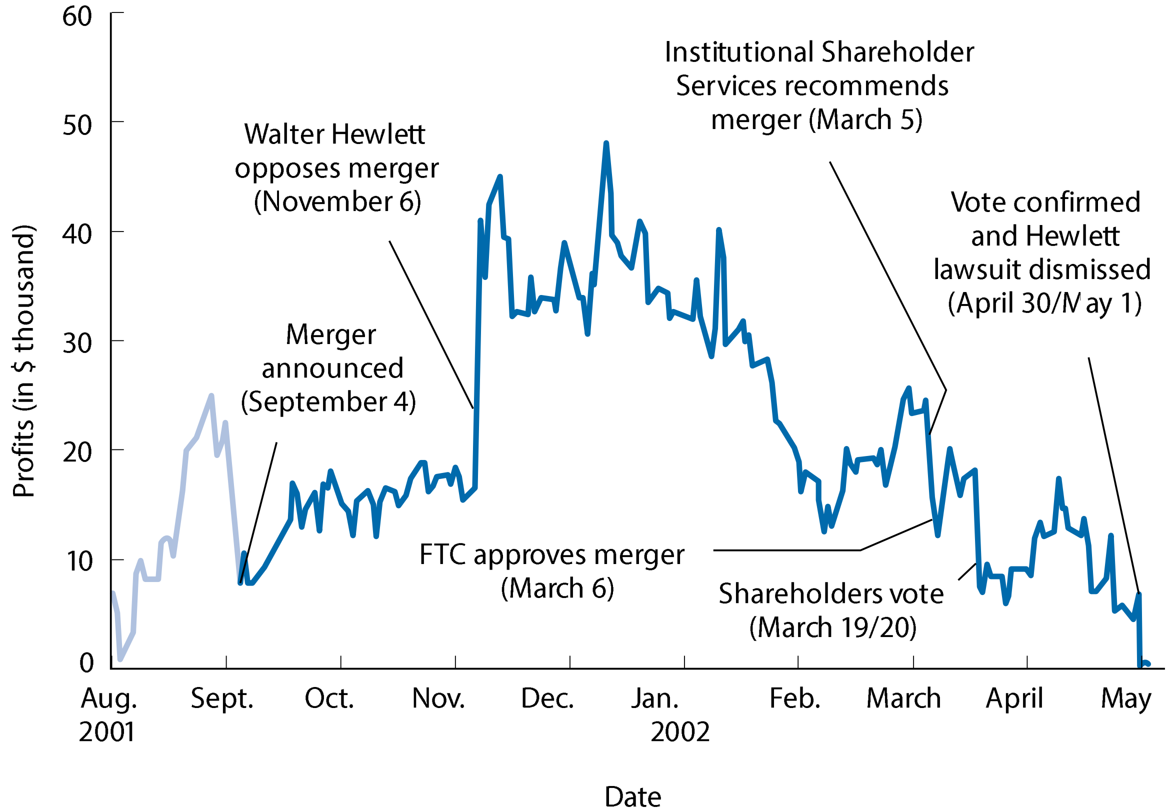
The Takeover Process: M&A Arbitrage Example

The HP-Compaq Merger Arbitrage

- HP offers 0.6325 shares of HP for each share of Compaq.
- Post tender, HP trades at $18.87 and Compaq at $11.08.
- Value of HP offer: $18.87 x 0.6325 = $11.9353.
- Either Compaq trades at a discount or HP at a premium.
- 'buy low → sell high' and/or 'sell high → buy low'.
  - Buy 10,000 Compaq shares and short 6,325 HP shares
  - Initial net = 6,325 x $18.87 – 10,000 x $11.08 = $8,553
  - Deal closes: tender 10,000 shares of Compaq and close your short position with the 6,325 HP shares received.
- The merger-arbitrage spread is the difference between the target's stock price and the (implied) offer price.

The Takeover Process: M&A Arbitrage Example

HP-Compaq merger arbitrage spread (per 10,000 Compaq sh.)



Source: Berk, DeMarzo, and Strangeland (2015, page 995)

The Takeover Process: Closing the Deal

Board and Shareholder Approval (or Rejection)

- The Board of Directors of the acquirer must approve the deal, and in some cases the shareholders of the acquirer too.
- The Board of Directors of the target sometimes has the power to decline an offer without referring it to the shareholders, but often it must present the offer to the shareholders to decide along with a recommendation.
- If the Board of target is receptive to the offer, and often it will negotiate a better offer, it is called a ‘friendly takeover’.
- If the Board of target is against the offer (e.g. price too low) and fights the takeover, it is called a ‘hostile takeover’. An acquirer pursuing aggressively a target is called a ‘raider’.

Takeover Defenses

A **hostile takeover** attempt usually triggers a fight between the acquirer and the target. The corporate governance of the target is then put under significant stress.

- The acquirer attempt to bypass the board of the target by making a proposal directly to the shareholders of the target (called a ‘tender offer’).
- The acquirer might also instigate a proxy fight by trying to replace the target board with its own nominees.
- The target has no choice but to fight back in an attempt to derail the hostile takeover or to get the raider to improve the terms of the its offer significantly.
- Over the years, ‘defenses’ against takeovers have been developed and deployed (likely bad corporate governance).

Takeover Defenses

- **Poison pill**: the mechanism provides the existing shareholders of the target with the right to buy shares of the target (or the acquirer) at a discounted price once conditions are met, but the acquirer is excluded from the mechanism. It increases the cost to acquirer the target accordingly.
- **Staggered Boards** (see previous lecture): need to have two successful proxy fights in a row to take control of board…
- **White Knights**: Board looks for another (friendly) acquirer.
- **Golden Parachutes**: entitlement to a generous severance package for executives of target in case of change of control.
- **Recapitalization**: pay out large dividend out of existing cash or funded by large debt offering (makes the target less attractive since financial and tax synergies are reduced or eliminated).