

## **FIN 423**

### **Interfirm Tender Offers & Mergers**

**Payoffs to Stockholders of Target & Bidder Firms**

**Sources of Gains/Motivations for Mergers**

**Types of Mergers**

- horizontal
- vertical
- conglomerate

### **Interfirm Mergers: Basic Facts**

**Mergers are (generally) friendly**

- they require the approval of both management teams/Boards before stockholders vote

**Mergers are often done in an exchange of securities**

- common stock of the bidding firm
- they are not taxable events for the target stockholders
  - unless they sell the bidder's stock

## Interfirm Tender Offers: Basic Facts

Tender offers are (generally) unfriendly

- target management is being by-passed by asking the stockholders to sell their stock, votes etc.

Tenders offers are often done for cash (or new debt securities)

- taxable events for the target stockholders
- strong incentive to complete them quickly
  - reduce the probability that a competing bidder will come along
  - cash/debt is quicker to use than stock

## How Do Stock Prices Behave? Jensen and Ruback (JFE, 1985):

### Tender offers:

- bidders gain 4%
- targets gain 30%

### Mergers:

- bidders gain 0%
- targets gain 20%

## **Why are premiums smaller for targets in mergers? -- Taxes:**

**(1) Larger premium in tender offers to make target stockholders as well off after taxes**

**(2) Could be that some of the 'cost' of the bid is used to buy off target management (to get them to cooperate), so the gains to stockholders are smaller**

**Both of these stories imply that the "pie" is being divided in different ways, with target shareholders getting a smaller piece**

## **Why are premiums smaller for bidders in mergers?**

**Could be that bidders know that tender offers are more expensive**

- **higher premiums required**
- **more chance of competition**
- **more lawyers/investment bankers fees**
- **so they only pursue deals that are likely to have large potential gains**

**There are some deals that remain profitable as mergers that would not be as hostile tender offers, so the samples are not comparable**

## Where Do the Gains Come From? Horizontal Mergers

Firms producing similar products in similar markets (i.e., the same industry)

- **Monopoly pricing:** could be gains from reducing competition
  - demand curve facing the firm becomes less elastic
  - price off the marginal revenue curve
  - reduce output, and increase profits

## Where Do the Gains Come From? Horizontal Mergers

Antitrust Division of the Justice Department & the Federal Trade Commission worry about horizontal mergers

- **Monopoly Pricing makes consumers worse off**
- **Efficiency increasing mergers make consumers better off**
  - more output at lower prices

## Where Do the Gains Come From? Vertical Mergers

Upstream firm buys a downstream firm (or vice versa)

- if one firm has a monopoly, can the merged firm increase profits by charging monopoly prices at both levels?
  - NO
- are there efficiency gains from internal rather than external contracting?
  - it depends: there is still an important transfer pricing problem

## Where Do the Gains Come From? Conglomerate Mergers

Firms in totally different industries

- perhaps there are efficiencies in management or some centralized service
  - doubtful today
  - may have been more important when centralized information systems first came into being (1960's)

## Diversification Gains from Mergers Who benefits?

### Not stockholders:

- they could do it on their own account by buying the stock of the two companies
- avoid paying a premium
- their holdings wouldn't have to be in fixed proportions

## Diversification Gains from Mergers Who benefits?

Stakeholders who are forced to hold undiversified portfolios of the stock of the bidder/target firm

- it is hard for them to diversify on their own accounts
- MANAGEMENT

## **Mergers as Financial Engineering**

**In the 1960's it was (naively) thought that if a bidder firm with a high P/E ratio bought a target firm with a low P/E ratio, the earnings from the target firm would be capitalized at the higher P/E ratio**

- **this presumes that firms, not projects, have a cost of capital**
- **this only makes sense if the target firm's earnings suddenly start growing at a rate that would justify the higher P/E ratio**
  - **because of efficiency gains?**

## **Where Do the Gains Come From? Efficient Contracting**

**Gains from mergers/tender offers must come from something that can't be done through direct contracting**

- **you actually have to buy the firm to realize the gain**

## **Where Do the Gains Come From? Efficient Contracting**

**If one firm has tax credits (e.g., losses in prior years), the IRS doesn't allow firms to sell these assets**

- **merger is the only way for a firm with taxable income to be able to use these credits**

## **Where Do the Gains Come From? Efficient Contracting**

**DuPont said it wanted Conoco for assured access to petroleum as inputs to its chemical production processes**

- **couldn't it simply sign a long-term supply arrangement?**

## **Where Do the Gains Come From? Efficient Contracting**

**Sometimes patents, or distribution networks, or brand names are used as rationalizations for mergers**

- **this assumes that the patent can't be sold or licensed at an efficient price**
- **that the distribution network can't be used or bought through a joint venture arrangement**
- **that the brand name from one product will extend to the acquired product**
  - **Kodak film and Verbatim floppy disks, or batteries**

## **Where Do the Gains Come From? Efficient Contracting**

**Trade-off between whether it is more costly to contract inside versus outside of the firm**

### **Corporate Control always changes**

- **the decision processes within the target firm**

## **Where Do the Gains Come From?**

### **Summary**

**(1) From a policy perspective, gains come from either efficiency gains (good), or from monopolization (bad).**

- **management shouldn't care, except that the probability of antitrust problems increase if the gains come from monopoly pricing**

**(2) Should always ask whether it is necessary to merge to capture the efficiency/pricing gains?**

- **are other contracting methods better than paying a premium to buy control?**

## **Where Do the Gains Come From?**

### **Summary**

**(3) Diversification should not increase firm value**

**(4) Since corporate control always changes, this may be the common factor explaining the gains.**

- **replace target management (& their decisions)**