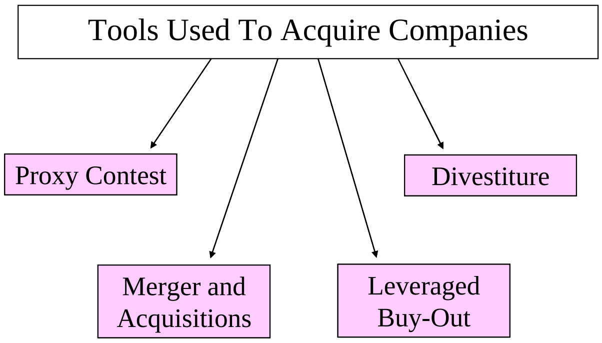
**FIN 302 Class Notes**

**Chapter21: Merger, Acquisitions, and corporate control**

When managers or directors take actions adverse to shareholders' interests, *agency costs* occurs.

There are four ways that the management of a corporation can change: a proxy contest, merger, leverage buy-out, and divestiture.




## Method 1: Proxy Contests

A proxy contest is an attempt to replace the board, and later management, by an outsider group or owners or other interested parties. Shareholders may delegate or "proxy" their vote on issues to others. A group may wage a proxy fight to elect directors. Control is decided by shareholders by how they vote or to whom they proxy their vote.

Most proxy fights by outsiders fail for existing managers have the advantages of using company funding to fight the proxy.

## Method 2: Mergers and Acquisitions

Corporate control is more likely to be changed through acquisition via two main ways.

**Merger**: the combination of two firms into one, is the first method of acquisition with the purchases assuming the assets and liabilities of the target firm. The acquired firm die away the former shareholders are given cash or securities, perhaps in the acquiring firm. For example: P&G bought Gillette Co. for $57 bl.

**Acquisition**: the purchase of the target company's stock. Cash or securities is paid, stockholders change places, and change is affected via board and management changes. A tender offer, where an unwanted acquirer invites shareholders to offer or tender their shares at a specified price to the acquirer. Here the acquired firm still exists but now it is owned by the acquiring firm.

## Method 3: Leveraged Buy-Outs

A firm's assets or stock is purchased by private group using borrowed funds. The change in corporate control is called a leveraged buy-out (LBO).

When the buyers are current or former managers, the term management buy-out (MBO) is used.

## Method 4: Divestitures, Spin-Offs, and Carve-Outs

Divisions, subsidiary corporations and assets may be sold to other businesses (divestiture) or sold the general public (Carve-Out) or to the existing shareholders (spin off).

## Motives or Mergers

Mergers are categorized as horizontal, vertical, or conglomerate, depending upon the nature of the business acquired.

**Horizontal Merger**: If a firm in a similar line of business is acquired.
**Vertical Merger**: If a supplier or a customer is acquired (vertical in the supply chain).
**Conglomerate merger**: is the acquisition of an unrelated line of business.

The motives for acquiring another business or its assets include the desire to replace existing management, and to improve efficiency or to produce synergies. The synergies or the value added by combining businesses may be explained by the following four areas.

**Economies of Scale**

The ability to derive reduced cost efficiencies through larger operations is an often-quoted benefit of mergers.

Horizontal mergers, in the same line of business, and from centralizing such functions as finance and accounting are likely to produce economies of scale.

**Economies of Vertical Integration**

Efficiencies related to controlling raw material supplies and final customer contact may benefit some industries.

Benefits in this area are often questionable.

**Combining Complementary Resources**

Some mergers involve firms where each has valuable assets which complement the other so the total becomes more efficient or better serves the customer.

**Mergers as a Use of Surplus Funds**
The presence of free cash flow in a mature firm often motivates managers to purchase other firms.

**Questionable Motives for Merger:**

**Diversification**

It is easier for shareholders to diversify than businesses via asset investment.
Diversification by itself is a poor reason for mergers, unless the merger is likely to produce value added (positive NPV's).

**Increase EPS (Bootstrapping)**
Bootstrapping merger-oriented firms are able to produce high earnings growth rates, attract added demand for shares and increased stock prices, and higher P/Es, which continues until the market assesses the actual added value of the mergers. The market usually is able to see through the "smoke and mirrors."

## Takeover Defense:

One takeover defense is commonly called **poison pill: c**ontingency plans to distribute large numbers of common stock to friendly shareholders if an unwanted takeover offer occurs.

Another takeover defense commonly used are generically named **shark repellent** where shareholders approve amendments to the charter and bylaws that require a large majority of shareholders to approve a merger, or make changes in the number of directors number and/or how directors are elected.

## The Benefits and Costs of Mergers

* Merger activity has occurred in cycles in this century, coinciding with periods of increased stock prices.
* Are mergers driven by economic opportunity or cheap financing? Probably both.
* Mergers tend to benefit selling shareholders. (buyers overpay for the target stock)
* Mergers tend to improve real productivity.
* The possibility of takeovers provides incentives for firm managers to manage efficiently, but are there other incentives for business productivity?