

THE MERGER PROCESS

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Introduction

This chapter focusses on two aspects of mergers. It first covers the middle stage of the merger process: that is, the deal-making stage, particularly in the circumstances of a hostile takeover. We look at the restraining rules and regulatory bodies that attempt to prevent unfairness.

Second, the chapter examines the question of what type of payment to make for the shares of the target firm. Should the acquirer offer cash, shares in itself or some other form of payment?

The City Code on Takeovers and Mergers

The City Code on Takeovers and Mergers provides the main governing rules for companies engaged in merger activity. The actions and responsibilities of quoted and unlisted public companies have been laid down over a period of more than 30 years. The Code has been developed in a self-regulatory fashion by City institutions, notably the London Stock Exchange, the Bank of England, the investment institutions, companies, banks, self-regulatory organizations (SROs) and the accounting profession. It is administered on a day-to-day basis by the Panel Executive of the City Panel on Takeovers and Mergers. The UK government formally recognizes the Takeover Panel's authority in the Financial Services and Markets Act 2000.

Statutory law is relatively unimportant in the regulation of mergers; its main contribution is to require that directors carry out their duty without prejudice in a fiduciary manner. That is, that they show trustworthy and faithful behavior for the benefit of shareholders equally.

The self-regulatory non-statutory approach is considered superior because it can provide a quick response in merger situations and be capable of regular adaptation to changed circumstances. There are frequent occurrences where companies try to bend or circumvent the rules and it is useful to have a system of regulation that is capable of continual review and is updated as new loopholes are discovered and exploited. Exhibit 12.1 gives some indication of the way in which the Takeover Panel responds to the changing types of unfairness by changing the rules. Statutory law would not have the same degree of flexibility. (Note that 'creeping' means achieving control of a company by buying up to 1 percent per year even though over 30 percent of the shares are already held and a formal bid has not been made.)

Flexibility is takeover body's key to escaping EU hangman

A review of the 'creeper' rule may stave off a threat from Brussels, says Jane Martinson

Plans by the Takeover Panel, the UK's acquisitions watchdog, to review the 'creeping' provision of its rulebook come at the same time as the threat of encroachment from the European Commission.

Flexibility and speedy answers to members' concerns are key weapons in the panel's fight against further legislation and government intervention.

Action on the creeper provision – which allows shareholders slowly to gain control of a company without launching a bid would follow a relative flurry of activity from a body keen to demonstrate the adaptability of its system of voluntary agreement.

Few in the City support more legislation or much change to the 'regulation by club rules' that underpins the Takeover Panel, a self-regulatory organisation staffed largely by secondees from City firms.

But the panel's recent decision to modernise its rules follows criticism that it was not doing enough to ensure fair play.

'If the panel does not show itself to be flexible it's putting its head in the

noose of European regulation,' said one institutional investor ...

The decision of Alistair Defriez, the body's director-general, to raise the creeper provision at the next panel meeting comes less than a month after the High Court rejected an unprecedented legal action based on it. Minority shareholders in Astec, the electronic power supply group, went to the High Court after Emerson, the US group, increased steadily its stake in Astec to 51 per cent by using the creeper provision

This decision, to be put to the 18-strong panel in July, has pleased several institutional investors ...

Mr Defriez is adamant that extra legislation should be avoided. 'The great thing about the code is that it isn't legislation carved in stone which nobody can change for 20 years. If we believe it [the panel] isn't working to the highest standards we change it,' he said. He added that a simple statement is enough to signal a change in the code.

Action using legislation, in contrast, 'could keep a court case going for years'.

EXHIBIT 12.1 Flexibility is the key

Source: *Financial Times*, 29 May 1998

The Code may not have the force of law but the Panel does have some powerful sanctions. These range from public reprimands to the shunning of Code defiers by the regulated City institutions – the Financial Services Authority, FSA, requires that no regulated firm (such as a bank, a broker or an adviser) should act for client firms that seriously break the Panel's rules. Practitioners in breach of the Code may be judged not fit and proper persons to carry on investment business by the FSA so there is considerable leverage over the City institutions who might otherwise be tempted to assist a rule breaker. The FSA may also take legal action under market abuse legislation – e.g. when there is share price manipulation. In rare cases the Panel may temporarily remove share-voting rights for particular shareholders.

The fundamental objective of the Takeover Panel regulation is to ensure fair and equal treatment for all shareholders. The main areas of concern are:

- shareholders being treated differently, for example large shareholders getting a special deal;
- insider dealing (control over this is assisted by statutory rules);
- target management action that is contrary to its shareholders' best interests; for example, the advice to accept or reject a bid must be in the shareholders' best interest, not that of the management;
- lack of adequate and timely information released to shareholders;
- artificial manipulation of share prices; for example an acquirer offering shares cannot make the offer more attractive by getting friends to push up its share price;
- the bid process dragging on and thus distracting management from their proper tasks.

The Office of Fair Trading (OFT) also takes a keen interest in mergers to ensure that they do not produce 'a substantial lessening of competition'. The OFT has the power to clear a merger. A small minority of proposed mergers may, after an OFT initial screening, be followed by a Competition Commission (CC) investigation. The CC is the ultimate arbiter in deciding if a substantial lessening of competition is likely. It conducts full detailed investigations and can insist on major changes to the merged entity. For example William Morrison was required to sell a number of Safeway supermarkets following their merger in 2004.¹ A CC inquiry may take several months to complete, during which time the merger bid is put on hold. Currently (2004) there is some confusion as to where the jurisdiction boundaries of the OFT and the CC lie because competitors of the merging firms can ask a tribunal (Competition Appeal Tribunal) to overturn a clearance by the OFT and insist on a CC referral, casting doubt on the power of the OFT. Another hurdle in the path of large intra-European Union mergers is their scrutiny by the European Commission in Brussels. This is becoming increasingly influential.

Action before the bid

Figure 12.1 shows the main stages of a merger. The acquiring firm usually employs advisers to help make a takeover bid. Most firms carry out mergers infrequently and so have little expertise in-house. The identification of suitable targets may be one of the first tasks of the advisers. Once these are identified there would be a period of appraising the target. The strategic fit would be considered and there would be a detailed analysis of what would be purchased. The product markets and types of customers could be investigated and there would be a financial analysis showing sales, profit and rates of return history. The assets and liabilities would be assessed and non-balance sheet assets such as employees' abilities would be considered.

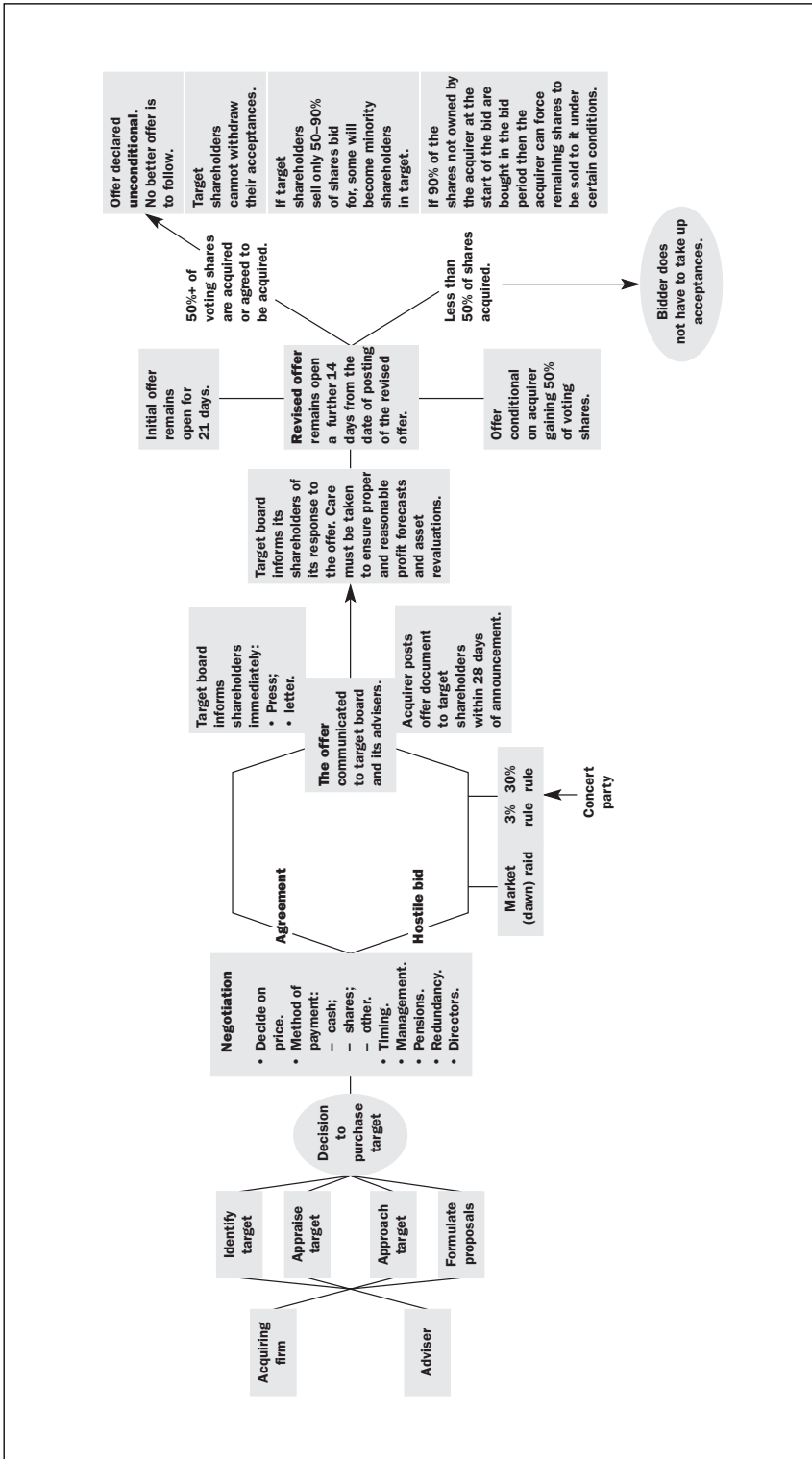


FIGURE 12.1
The merger process

If the appraisal stage is satisfactory the firm may approach the target. Because it is often cheaper to acquire a firm with the agreement of the target management, and because the managers and employees have to work together after the merger, in the majority of cases discussions take place designed to produce a set of proposals acceptable to both groups of shareholders and managers.

During the negotiation phase the price and form of payment need to be decided upon. In most cases the acquirer has to offer a bid premium. This tends to be in the range of 20 to 100 percent of the pre-bid price. The average is about 30–50 percent. The timing of payment is also considered. For example, some mergers involve ‘earn-outs’ in which the selling shareholders (usually the same individuals as the directors) receive payment over a period of time dependent on the level of post-merger profits. The issue of how the newly merged entity will be managed will also be discussed – who will be chief executive? Which managers will take particular positions? Also the pension rights of the target firm’s employees and ex-employees have to be considered, as does the issue of redundancy, especially the removal of directors – what pay-offs are to be made available?

If agreement is reached then the acquirer formally communicates the offer to the target’s board and shareholders. This will be followed by a recommendation from the target’s board to its shareholders to accept the offer.

If, however, agreement cannot be reached and the acquirer still wishes to proceed a hostile bid is created. One of the first stages might be a ‘dawn raid’. This is where the acquirer acts with such speed in buying the shares of the target company that the raider achieves the objective of obtaining a substantial stake in the target before the target’s management have time to react. The acquirer usually offers investors a price which is significantly higher than the closing price on the previous day. This high price is only offered to those close to the market and able to act quickly and is contrary to the spirit of the Takeover Panel’s rules, because not all shareholders can participate. It breaks the rules in another way: the sellers in a ‘dawn raid’ are not aware of all relevant information, in this case that a substantial stake is being accumulated. The Takeover Panel insists that the purchase of 10 percent or more of the target shares in a period of seven days is not permitted if this would take the holding to more than 15 percent (except if the shares are purchased from a single seller).² Once a company becomes a bid target any dealings in the target’s shares by the bidder (or an associate) must be publicly disclosed no later than 12 noon on the business day following the transaction. Furthermore, once an offer is underway, any holder of 1 percent or more must disclose dealings by midday of the next business day.

An important trigger point for disclosure of shareholdings in a company, whether the subject of a merger or not, is the 3 percent holding level. If a 3 percent stake is owned then this has to be declared to the company. This disclosure rule is designed to allow the target company to know who is buying its shares and to give it advance warning of a possible takeover raid. The management can then prepare a defense and present information to shareholders should the need arise.

If a company builds up a stake of more than 30 percent of the shares carrying voting rights the Takeover Panel rules usually oblige it to make a cash bid for all of the target company's shares (or a share offer with a cash alternative) at the highest price paid in the previous 12 months. A 30 percent stake often gives the owner a substantial amount of power. It is very difficult for anyone else to bid successfully for the firm when someone already has 30 percent. It is surprising how often one reads in the financial press that a company or individual has bought a 29.9 percent holding so that they have as large a stake as possible without triggering a mandatory bid.

Sometimes, in the past, if a company wanted to take over another it would, to avoid declaring at the 3 percent level (or 5 percent as it was then), or to avoid bidding at the 30 percent level, sneak up on the target firm's management and shareholders. It would form a 'concert party' by persuading its friends, other firms and individuals to buy stakes in the target. Each of these holdings would be below the threshold levels. When the acquirer was ready to pounce it would already have under its control a significant, if not a majority, controlling interest. Today all concert party holdings are lumped together for the purposes of disclosure and trigger points.

A tactic that has become common recently is for a potential bidder to announce that they are thinking of making a bid rather than actually doing it – they make an '*indicative offer*' (dubbed a virtual bid) saying they might bid but not committing themselves to the expense and strict timetable of a formal offer. Shareholders in targets may gain from having potential bidders announce an interest in buying their shares and are in favor of allowing time for the bid to be put together. On the other hand, it is not in the shareholders' interest for the management to continually feel under siege. The Takeover Panel permits indicative offers, but after a few weeks (generally six to eight) without a genuine offer emerging it declares that the potential bidder has to 'put up or shut up' before a deadline date.

Traps for bidders to avoid

If the bidder purchases shares carrying 10 percent or more of the voting rights in the offer period or in the previous 12 months of a bid, the offer must include a cash alternative at the highest price paid by the bidder. A potential bidder should be careful not to buy any shares at a price higher than a fair value.

If the bidder buys shares in the target at a price above the offer price during a bid the offer must be increased to that level. So, be careful of topping up acceptances by offering a high price to a few shareholders.

The bid

In both a friendly and a hostile bid the acquirer is required to give notice to the target's board and its advisers that a bid is to be made. The press and the Stock Exchange are usually also informed. The target management must immediately inform their shareholders (and the Takeover Panel). This is done through an announcement to the Stock Exchange and a press notice, which must be quickly followed by a letter explaining the situation. In a hostile bid the target management tend to use phrases like 'derisory offer' or 'wholly unacceptable'.

Within 28 days of the initial notice of an intention to make an offer the offer document has to be posted to each of the target's shareholders. Details of the offer, the acquirer and its plans will be explained. If the acquisition would increase the total value of the acquirer's assets by more than 15 percent the acquirer's shareholders need to be informed about the bid. If the asset increase is more than 25 percent then shareholders must vote in favor of the bid proceeding. They are also entitled to vote on any increase in authorized share capital.

The target management have 14 days in which to respond to the offer document. Assuming that they recommend rejection, they will attack the rationale of the merger and the price being offered. They may also highlight the virtues of the present management and reinforce this with revised profit forecasts and asset revaluations. There follows a period of attack and counter-attack through press releases and other means of communication. Public relations consultants may be brought in to provide advice and to plan tactics.

The offer remains open for target shareholders to accept for 21 days from the date of posting the offer document. If the offer is revised it must be kept open for a further 14 days from the posting date of the revision.³ However, to prevent bids from dragging on endlessly the Panel insists that the maximum period for a bid is 60 days from the offer document date (posting day). The final offer date is day 46, which allows 14 days for acceptances. There are exceptions: if another bidder emerges, then it has 60 days, and its 60th day becomes the final date for both bidders; or if the Board of the target agrees to an extension; if the bid is referred to the CC the Panel can 'stop the clock'. If the acquirer fails to gain control within 60 days then it is forbidden to make another offer for a year to prevent continual harassment.

Exhibit 12.2, which reproduces an article on Westminster Health Care, shows that despite a 21-day rule, target shareholders have become accustomed to a 60-day period in which to make up their minds.

Westminster Health Care: quick bid fails

Sameena Ahmad

Institutions joined forces this week to stamp out sudden-death takeover bids by firmly rejecting Westminster Health Care's hostile offer for Goldsborough, a smaller nursing home group.

Confident of City support in the light of the target's share price weakness, Westminster quickly declared its £70m offer final, shortening the timetable for acceptance from the usual 60 days to 21 days. Three-week 'bullet' bids are permissible, but have proved unpopular with investors used to a 60-day timetable, in which the bidder normally raises its offer ...

One leading Goldsborough investor called Westminster's offer 'unduly aggressive', forcing institutions to make snap decisions and preventing the target from mounting a proper defence.

He added: 'Most fund managers are simple folk: stroke us and we roll over, but twist our arms and we bite back.'

Another Goldsborough shareholder, with some 6 per cent of its shares, said the 21-day issue was 'very relevant' to his rejection of the offer. 'This is a small company where there is little guidance from analysts. We need time to properly assess tricky points like asset values.'

Full-term takeovers offer more than just time to reflect. They give rival bidders the time to make a higher offer and advisers and underwriters more chances to earn fees ...

'The 60-day bid process is a ritual,' sighed Westminster chief executive Pat Carter. 'We probably should have followed it.'

EXHIBIT 12.2 Westminster Health Care: a quick bid fails

Source: *Investors Chronicle*, 19 July 1996

After the bid

Usually an offer becomes unconditional when the acquirer has bought, or has agreed to buy, 50 percent of the target's shares. Prior to the declaration of the offer as unconditional the bidding firm would have said in the offer documents that the offer is conditional on the acquirer gaining (usually) 50 percent of the voting shares. This allows the bidding firm to receive acceptances from the target shareholders without the obligation to buy.⁴ Once it is declared unconditional the acquirer is making a firm offer for the shares that it does not already have, and indicating that no better offer is to follow. Before the announcement of unconditionality those target shareholders who accepted the offer are entitled to withdraw their acceptance – after it, they are forbidden to do so.

Usually in the days following unconditionality the target shareholders who have not already accepted quickly do so. The alternative is to remain a minority shareholder – still receiving dividends but with power concentrated in the hands of a majority shareholder. There is a rule to avoid the frustration of having a small group of shareholders stubbornly refusing to sell. If the acquirer has bought nine-tenths of the shares it bid for, it can, within four months of the original offer, insist that the remaining shareholders sell at the final offer price.

If the bid has lapsed or not been declared unconditional the bidder cannot bid again for a 12-month period. However, the bidder is allowed to bid again if a bid is made by another company or the bidders renewed offer is recommended by the target management.

The flexibility of the self-regulatory system is seen in Exhibit 12.3 where the standard bidding rules were laid aside to allow an auction approach to the purchase of Debenhams. Under the 'accelerated auction' rules, introduced in 2002, if, after the standard 46-day offer period, rival bidders remain, each will be given a day to respond to the other's bid for a few days, then final sealed bids decide the fate of the target.

Takeover Panel sets rules for Debenhams fight

Alison Smith

The Takeover Panel yesterday set the stage for further offers in the long-running bid tussle for Debenhams, as it revealed how the two private equity rivals for the group could battle it out to a conclusion by early November.

Yesterday the group's shares closed up 1/2p at 472 1/4p, well ahead of the recommended offer by Baroness Retail at 455p a share, which values the company at £1.66bn. Baroness is led by CVC Capital Partners and Texas Pacific Group.

It looks likely that Laragrove, the consortium led by Permira which

launched a £1.54bn bid in May, will make a higher offer. ...

... The Panel's procedure sets an auction start date of 4pm on October 31, with any higher offer to be announced at 5pm. The lower bidder in each round will be able to revise its bid by 4pm the following day for announcement an hour later.

If the contest has not been decided by Monday November 3, both sides will be invited to submit final sealed bids by 1pm the following day.

EXHIBIT 12.3 Takeover Panel sets rules for Debenhams' takeover

Source: *Financial Times* 15 October 2003

Defense tactics

Roughly one-half of UK hostile bids are unsuccessful. Here are a few of the tactics employed by target managers to prevent a successful bid or to reduce the chances of a bid occurring.

Before bidding starts

- **Eternal vigilance** Be the most effective management team and educate shareholders about your abilities and the firm's potential. Cultivate good relationships with unions, work force and politicians. Polish social image.
- **Defensive investments** Your firm buys a substantial proportion of the shares in a friendly firm, and it has a substantial holding of your shares.
- **Forewarned is forearmed** Keep a watch on the share register for the accumulation of shares by a potential bidder.

After bidding has started

- **Attack the logic of the bid** Also attack the quality of the bidder's management.
- **Improve the image of the firm** Use revaluation, profit projections, dividend promises, public relations consultants.
- **Attack the value creating (destroying) record of the bidder.**
- **Try to get an OFT block or Competition Commission inquiry.**
- **Encourage unions, the local community, politicians, customers and suppliers to lobby on your behalf.**
- **White Knight** Invite a second bid from a friendly company.
- **Lobby your major shareholders.**
- **Buy another business to make the firm too big or incompatible with the bidder.**
- **Arrange a management buyout of your company.**
- **Begin litigation against the bidder** Bidders sometimes step over the legal boundary in their enthusiasm – e.g. false statements, gaining private information – a court case could be embarrassing.
- **Employee share ownership plans (ESOPs)** These can be used to buy a substantial stake in the firm and may make it more difficult for a bidder to take it over.
- **Share repurchase** Reduces the number of shares available in the market for bidders.

The following tactics are likely to be frowned upon or banned by the Takeover Panel in the UK, but are used in the USA and in a number of continental European countries.

- **Poison pills** Make yourself unpalatable to the bidder by ensuring additional costs should it win – for example, target shareholders are allowed to buy shares in target or acquirer at a large discount should a bid be successful (not possible in the UK).
- **Crown jewels defense** Sell off the most attractive parts of the business.
- **Pac-Man defense** Make a counter-bid for the bidder.
- **Asset lock-up** A friendly buyer purchases those parts of the business most attractive to the bidder.
- **Stock lock-up (White squire)** Target shares are issued to a friendly company or individual(s).
- **Golden parachutes** Managers get massive pay-offs if the firm is taken over.
- **Give in to greenmail** Key shareholders try to obtain a reward (for example, the repurchase of their shares at premium) from the company for not selling to a hostile bidder or for not becoming a bidder themselves. (Green refers to the color of a US dollar.)
- **Limit voting rights** In some European states the management have the ability to limit voting rights to say a maximum of 15 percent regardless of the actual share holding.

Paying for the target's shares

Table 11.1 in Chapter 11 showed the relative importance of alternative methods of paying for the purchase of shares in another company over three decades. The relative popularity of each method has varied considerably over the years but in most years cash is the most attractive option, followed by shares, and finally the third category, comprising mostly debentures, loan stocks, convertibles and preference shares.

The figures given in Table 11.1 tend to give a slightly distorted view of the financial behavior of acquiring firms. In many cases where cash is offered to the target shareholders the acquirer does not borrow that cash or use cash reserves. Rather, it raises fresh funds through a rights issue of shares before the takeover bid.

The table may also be misleading in the sense that a substantial proportion of mergers do not fall neatly into the payment categories. Many are mixed bids, providing shareholders of the target firms with a variety of financial securities or offering them a choice in the consideration they wish to receive, for example cash or shares, shares or loan stock. This is designed to appeal to the widest range of potential sellers.

Cash

One of the advantages of using cash for payment is that the acquirer's shareholders retain the same level of control over their company. That is, new shareholders from the target have not suddenly taken possession of a proportion of the acquiring firm's voting rights, as they would if the target shareholders were offered shares in the acquirer. Sometimes it is very important to shareholders that they maintain control over a company by owning a certain proportion of the firm's shares. Someone who has a 50.1 percent stake may resist attempts to dilute that holding to 25 percent even though the company may more than double in size.

The second major advantage of using cash is that its simplicity and preciseness give a greater chance of success. The alternative methods carry with them some uncertainty about their true worth. Cash has an obvious value and is therefore preferred by vendors, especially when markets are volatile.

From the point of view of the target's shareholders, cash has the advantage – in addition to being more certain in its value – that it also allows the recipients to spread their investments through the purchase of a wide-ranging portfolio. The receipt of shares or other securities means that the target shareholder either keeps the investment or, if diversification is required, has to incur transaction costs associated with selling the shares.

A disadvantage of cash to the target shareholders is that they may be liable for capital gains tax. This is payable when a gain is 'realized'. If the target shareholders receive cash on shares which have risen in value they may pay tax at

their marginal rate: in the UK if they are 22 percent taxpayers on the last pound earned they will pay 22 percent on the gain; if they are 40 percent taxpayers they pay 40 percent on the gain (although the amount payable can be reduced by holding shares for a long period). If, on the other hand, the target shareholders receive shares in the acquiring firm then their investment gain is not regarded as being realized, so no capital gains tax is payable at that time. The tax payment will be deferred until the time of the sale of the new shares – assuming an overall capital gain is made. (Note that some investment funds, e.g. pension funds do not pay CGT and so this problem does not arise. Also, CGT can be reduced by tax free allowances, taper relief and capital losses on other investments and so many shareholders will not consider CGT a burden.)

In certain circumstances the Takeover Panel insists on a cash offer or a cash alternative to an all-share offer.

One further consideration: borrowing cash that is then paid out for the targets shares may be a way of adjusting the financial gearing (debt to equity ratio) of the firm. On the other hand, the firm may already have high borrowings and be close to breaching loan covenants and so is reluctant to borrow more.

Shares

There are two main advantages to target shareholders of receiving shares in the acquirer rather than cash. First, capital gains tax can be postponed because the investment gain is not realized. Second, they maintain an interest in the combined entity. If the merger offers genuine benefits the target shareholders may wish to own part of the combined entity.

To the acquirer, an advantage of offering shares is that there is no immediate outflow of cash. In the short term, this form of payment puts less pressure on cash flow. However the firm may consider the effect on the capital structure of the firm and the dilution of existing shareholders' positions – *see* Exhibit 12.4.

A second reason for using shares as the consideration is that the price–earnings ratio (PER) game can be played. Through this companies can increase their earnings per share (EPS) by acquiring firms with lower PERs than their own. The share price can rise (under certain conditions) despite there being no economic value created from the merger.

Imagine two firms, Crafty plc and Sloth plc. Both earned £1m last year and had the same number of shares. Earnings per share on an historic basis are identical. The difference between the two companies is the stock market's perception of earnings growth. Because Crafty is judged to be a dynamic go-ahead sort of firm with management determined to improve earnings per share by large percentages in future years it is valued at a high PER of 20.

Sloth, on the other hand, is not seen by investors as a fast-moving firm. It is considered to be rather sleepy. The market multiplies last year's earnings per share by only a factor of 10 to determine the share price – *see* Table 12.1.

Vodafone's winning formula is now seen as a recipe for producing wrong numbers

£113bn takeover was once hailed as a smart move. Not any more, says Dan Roberts

The end of telecommunications investment bubble has put many of last year's takeovers and mergers under the spotlight.

Now attention is turning towards the biggest of them all – Vodafone's £113bn takeover of Mannesmann.

It had looked smart compared with deals struck by rivals such as British Telecommunications because it used highly-rated shares as currency rather than saddling Vodafone with unsustainable debt as a result of paying cash.

Assembling the world's biggest mobile phone company to provide mobile internet access seemed a winning formula.

But renewed scepticism about the growth potential of mobile internet serv-

ices has led investors to question whether Mannesmann, and Vodafone's string of other acquisitions over the last 18 months, were worth the fourfold dilution of existing shareholders' holdings.

Vodafone shares have fallen 18 per cent since it produced its annual results on May 29, underperforming the sector as analysts have reduced forecasts. Its market capitalisation this week fell below £100bn – at the peak it was £270bn – with the shares at their lowest since October 1998.

Some of the pricing pressure reflects a share overhang, with recipients of Vodafone paper cashing in.

EXHIBIT 12.4 Vodafone: Producing wrong numbers

Source: *Financial Times*, 28 June 2001

TABLE 12.1

Illustration of the price to earnings ratio game – Crafty and Sloth

	Crafty	Sloth
Current earnings	£1m	£1m
Number of shares	10m	10m
Earnings per share	10p	10p
Price to earnings ratio	20	10
Share price	£2	£1

Because Crafty's shares sell at a price exactly double that of Sloth it would be possible for Crafty to exchange one of its shares for two of Sloth's. (This is based on the assumption that there is no bid premium, but the argument that follows works just as well even if a reasonable bid premium is paid.)

If Crafty buys all the shares in Sloth its share capital rises by 50 percent, from ten million shares to 15 million shares. However EPS are one-third higher. If the stock market still puts a high PER on Crafty's earnings, perhaps because

investors believe that Crafty will liven up Sloth and produce high EPS growth because of their more dynamic management, then the value of Crafty increases and Crafty's shareholders are satisfied.

Each old shareholder in Crafty has experienced an increase in earnings per share and a share price rise of 33 percent. Also, previously Sloth's shareholders owned £10m of shares in Sloth; now they own £13.33m of shares (*see* Table 12.2).

TABLE 12.2
Crafty after an all-share merger with Sloth

	Crafty
Earnings	£2m
Number of shares	15m
Earnings per share	13.33p
Price to earnings ratio	20
Share price	267p

This all seems rational and good, but shareholders are basing their valuations on the assumption that managers will deliver on their promise of higher earnings growth through operational efficiencies, etc. Managers of companies with high PER may see an easier way of increasing EPS and boosting share price. Imagine you are managing a company which enjoys a high PER. Investors in your firm are expecting you to produce high earnings growth. You could try to achieve this through real entrepreneurial and/or managerial excellence, for example by product improvement, achieving economies of scale, increased operating efficiency, etc. Alternatively you could buy firms with low PERs and not bother to change operations. In the long run you know that your company will produce lower earnings because you are not adding any value to the firms that you acquire, you are probably paying an excessive bid premium to buy the present earnings and you probably have little expertise in the new areas of activity.

However, in the short run, EPS can increase dramatically. The problem with this strategy is that to keep the earnings on a rising trend you must continue to keep fooling investors. You have to keep expanding at the same rate to receive regular boosts. One day expansion will stop; it will be revealed that the underlying economics of the firms bought have not improved (they may even have worsened as a result of neglect), and the share price will fall rapidly. This is another reason to avoid placing too much emphasis on short-term EPS figures. The Americans call this the boot strap game. It can be very lucrative for some managers who play it skilfully. However there can be many losers – society, shareholders, employees.

There are some significant dangers in paying shares for an acquisition, as Buffett makes clear in Exhibit 12.5.

Wealth for shareholders from mergers: the view of Warren Buffett

Our share issuances follow a simple basic rule: we will not issue shares unless we receive as much intrinsic business value as we give. Such a policy might seem axiomatic. Why, you might ask, would anyone issue dollar bills in exchange for fifty-cent pieces? Unfortunately, many corporate managers have been willing to do just that.

The first choice of these managers in making acquisitions may be to use cash or debt. But frequently the CEO's cravings outpace cash and credit resources (certainly mine always have). Frequently, also, these cravings occur when his own stock [shares] is selling far below intrinsic business value. This state of affairs produces a moment of truth. At that point, as Yogi Berra has said, 'You can observe a lot just by watching.' For shareholders then will find which objective the management truly prefers – expansion of domain or maintenance of owners' wealth.

The need to choose between these objectives occurs for some simple reasons. Companies often sell in the stock market below their intrinsic business value. But when a company wishes to sell out completely, in a negotiated transaction, it inevitably wants to – and usually can – receive full business value in whatever kind of currency the value is to be delivered. If cash is to be used in payment, the seller's calculation of value received couldn't be easier. If stock [shares] of the buyer is to be currency, the seller's calculation is still relatively easy: just figure the market value in cash of what is to be received in stock.

Meanwhile, the buyer wishing to use his own stock as currency for the purchase has no problems if the stock is selling in the market at full intrinsic value.

But suppose it is selling at only half intrinsic value. In that case, the buyer is faced with the unhappy prospect of

using a substantially undervalued currency to make its purchase.

Ironically, were the buyer to instead be a seller of its entire business, it too could negotiate for, and probably get, full intrinsic business value. But when the buyer makes a partial sale of itself – *and that is what the issuance of shares to make an acquisition amounts to* – it can customarily get no higher value set on its shares than the market chooses to grant it.

The acquirer who nevertheless barges ahead ends up using an undervalued (market value) currency to pay for a fully valued (negotiated value) property. In effect, the acquirer must give up \$2 of value to receive \$1 of value. Under such circumstances, a marvelous business purchased at a fair sales price becomes a terrible buy. For gold valued as gold cannot be purchased intelligently through the utilization of gold – or even silver – valued as lead.

If, however, the thirst for size and action is strong enough, the acquirer's manager will find ample rationalizations for such a value-destroying issuance of stock. Friendly investment bankers will reassure him as to the soundness of his actions. (Don't ask the barber whether you need a haircut.)

A few favorite rationalizations employed by stock-issuing managements follow:

(a) 'The company we're buying is going to be worth a lot more in the future.' (Presumably so is the interest in the old business that is being traded away; future prospects are implicit in the business valuation process. If 2X is issued for X, the imbalance still exists when both parts double in business value.)

(b) 'We have to grow.' (Who, it might be asked, is the 'We'? For present shareholders, the reality is that all existing businesses shrink when shares are

issued. Were Berkshire to issue shares tomorrow for an acquisition, Berkshire would own everything that it now owns plus the new business, but *your* interest in such hard-to-match businesses as See's Candy Shops, National Indemnity, etc. would automatically be reduced. If (1) your family owns a 120-acre farm and (2) you invite a neighbor with 60 acres of comparable land to merge his farm into an equal partnership – with you to be managing partner, then (3) your managerial domain will have grown to 180 acres but you will have permanently shrunk by 25% your family's ownership interest in both acreage and crops. Managers who want to expand their domain at the expense of owners might better consider a career in government.) ...

... There are three ways to avoid destruction of value for old owners when shares are issued for acquisitions. One is to have a true business-value-for-business-value merger, ... Such a merger attempts to be fair to shareholders of *both* parties, with each receiving just as much as it gives in terms of intrinsic business value ... It's not that acquirers wish to avoid such deals, it's just that they are very hard to do.

The second route presents itself when the acquirer's stock sells at or above its intrinsic business value. In that situation, the use of stock as currency actually may enhance the wealth of the acquiring company's owners ...

... The third solution is for the acquirer to go ahead with the acquisition, but then subsequently repurchase a quantity of shares equal to the number issued in the merger. In this manner, what originally was a stock-for-stock merger can be converted, effectively, into a cash-for-stock acquisition. Repurchases of this kind are damage-repair moves. Regular readers will correctly guess that we much prefer repurchases that directly enhance the wealth of owners instead of repurchases that merely repair

previous damage. Scoring touchdowns is more exhilarating than recovering one's fumbles.

The language utilized in mergers tends to confuse the issues and encourage irrational actions by managers. For example, 'dilution' is usually carefully calculated on a pro forma basis for both book value and current earnings per share. Particular emphasis is given to the latter item. When that calculation is negative (dilutive) from the acquiring company's standpoint, a justifying explanation will be made (internally, if not elsewhere) that the lines will cross favorably at some point in the future. (While deals often fail in practice, they never fail in projections – if the CEO is visibly panting over a prospective acquisition, subordinates and consultants will supply the requisite projections to rationalize any price.) Should the calculation produce numbers that are immediately positive – that is, anti-dilutive – for the acquirer, no comment is thought to be necessary.

The attention given this form of dilution is overdone: current earnings per share (or even earnings per share of the next few years) are an important variable in most business valuations, but far from all-powerful.

There have been plenty of mergers, non-dilutive in this limited sense, that were instantly value-destroying for the acquirer. And some mergers that have diluted current and near-term earnings per share have in fact been value-enhancing. What really counts is whether a merger is dilutive or anti-dilutive in terms of intrinsic business value (a judgment involving consideration of many variables). We believe calculation of dilution from this viewpoint to be all-important (and too seldom made).

A second language problem relates to the equation of exchange. If Company A announces that it will issue shares to merge with Company B, the process is customarily described as

'Company A to Acquire Company B', or 'B Sells to A'. Clearer thinking about the matter would result if a more awkward but more accurate description were used: 'Part of A sold to acquire B' or 'Owners of B to receive part of A in exchange for their properties'. In a trade, what you are giving is just as important as what you are getting ...

... Managers and directors might sharpen their thinking by asking themselves if they would sell 100% of their business on the same basis they are being asked to sell part of it. And if it isn't smart to sell all on such a basis, they should ask themselves why it is smart to sell a portion. A cumulation of small managerial stupidities will produce a major stupidity – not a major triumph. (Las Vegas has been built upon the wealth transfers that occur when people engage in seemingly-small disadvantageous capital transactions.) ...

... Finally, a word should be said about the 'double whammy' effect upon

owners of the acquiring company when value-diluting stock issuances occur. Under such circumstances, the first blow is the loss of intrinsic business value that occurs through the merger itself. The second is the downward revision in market valuation that, quite rationally, is given to that now-diluted business value. For current and prospective owners understandably will not pay as much for assets lodged in the hands of a management that has a record of wealth-destruction through unintelligent share issuances as they will pay for assets entrusted to a management with precisely equal operating talents, but a known distaste for anti-owner actions. Once management shows itself insensitive to the interests of owners, shareholders will suffer a long time from the price/value ratio afforded their stock (relative to other stocks), no matter what assurances management gives that the value-diluting action taken was a one-of-a-kind event.

EXHIBIT 12.5 Wealth for shareholders from mergers

Source: Warren Buffett's letter to shareholders in the *Berkshire Hathaway Annual Report 1982*

Other types of finance

Alternative forms of consideration including debentures, loan stock, convertibles and preference shares (described in Chapters 16 and 17) are unpopular, largely because of the difficulty of establishing a rate of return on these securities that will be attractive to target shareholders. Also, these securities often lack marketability and voting rights over the newly merged company.

Conclusion

The bid process is fairly complex with rules to be obeyed by both the bidder and the target.

The bid process is fairly complex with rules to be obeyed by both the bidder and the target. It is understandable that many company managements feel the necessity of holding hands with the experts in the investment banks. Be careful though; the cost of this

advice can be exorbitant. It is interesting that Philip Green, the billionaire owner of BHS and Arcadia, generally prefers to talk directly with the manage-

ment and shareholders of potential targets rather than pay M&A specialists to suggest strategic moves, analyze and negotiate for him, speeding up the process and saving money – when you are using your own money the pain of the £1m check is more acutely felt – although he brings the bankers in for specific tasks later.

Investment banks can be useful for key activities, including certain stages in the negotiations. They can advise on the type of finance to be used to purchase the target's shares. More significantly, they can assist with the raising of fresh funds, e.g. a bond or share issue – the underwriting fees on these can be high, so be wary of signing blank checks. They can guide you through the Takeover Panel rules. Finally, the City experts may be able to help with the valuation of the target. The next chapter will allow you to understand the rationale and drawbacks of the techniques they are likely to use.

Websites

www.berkshirehathaway.com	Berkshire Hathaway
www.ft.com	Financial Times
www.kpmg.co.uk	KPMG
www.londonstockexchange.com	London Stock Exchange
www.thetakeoverpanel.org.uk	The Takeover Panel
www.competition-commission.org.uk	Competition Commission
www.offt.gov.uk	Office of Fair Trading

Notes

- 1 This was actually negotiated between the OFT and Morrisons following the Competition Commission's ruling.
- 2 Or if the purchases are immediately before the buyer announces a firm intention to make an offer if the offer is agreed by the target Board.
- 3 If an offer is revised all shareholders who accepted an earlier offer are entitled to the increased payment.
- 4 If 90 percent of the target shares are offered, the bidder must proceed (unless there has been a material adverse change of circumstances). At lower levels of acceptance, it has a choice of whether to declare unconditionality.