

Chapter 42

TAKING CONTROL OF A COMPANY

A peek behind the scenes of investment banking

At any given time, a company can have several valuations, depending on the point of view of the buyer and the seller and their expectations on future profits and synergies. This variety sets the stage for negotiation but, needless to say, a transaction will take place only if common ground can be found – i.e. if the seller's minimum price does not exceed the buyer's maximum price.

The art of negotiation consists of allocating the value of the anticipated synergies between the buyer and the seller, and in finding an equilibrium between their respective positions, so that both come away with a good deal. The seller receives more than the value for the company on a standalone basis because he pockets part of the value of the synergies the buyer hopes to unlock. Similarly, the buyer pays out part of the value of the synergies, but has still not paid more than the company is worth to him.

Transactions can also result from erroneous valuations. A seller might think his company has reached a peak, for example, and the buyer that it still has growth potential. But generally, out-and-out deception is rarer than you might think. It's usually only in hindsight that we say we made a killing and that the party on the other side of the transaction was totally wrong!

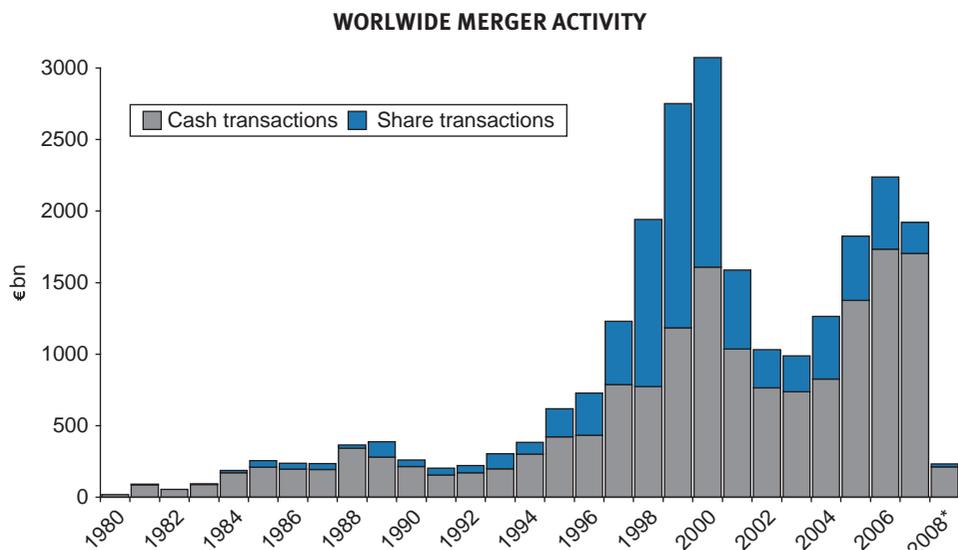
In this chapter we will focus on the acquisition of one company by another. We will not consider industrial alliances, i.e. commercial or technology agreements negotiated directly between two companies which do not involve a transaction of the equity of either of them. Before examining the various negotiation tactics and the purchase of a listed company, let us first take a look at the merger and acquisition phenomenon and the economic justification behind a merger.

Section 42.1

THE RISE OF MERGERS AND ACQUISITIONS

1/MERGER AND ACQUISITION WAVES

Acquisitions can be paid for either in cash or in shares. Generally speaking, share transactions predominate when corporate valuations are high, as they were in 1999–2000, because absolute values do not have to be determined.



Conversely, when the market is bearish, cash payments are more attractive to both parties. The seller receives cold, hard cash which will not lose value as shares might, while the buyer is reluctant to issue new shares at prices he/she considers to be a discount to their intrinsic value.

Source: Thomson One Banker.

As shown in the above graph, mergers and acquisitions tend to come in waves:

- In the 1960s conglomerates were all the rage. ITT, Gulf & Western, Fiat, Schneider and many others rose to prominence during this period. The parent company was supposedly able to manage the acquired subsidiaries better, plus meet their capital needs. Most transactions were paid for with shares.
- In the 1980s, most acquisitions were paid for in cash. Many of the big conglomerates formed in the 1960s were broken up. They had become less efficient, poorly managed and valued at less than the sum of the values of their subsidiaries.
- In the 1990s and 2000s, companies within the same sector joined forces, generally in share transactions: Procter & Gamble–Gillette, Glaxo Wellcome–SmithKline Beecham, etc.

Shleifer and Vishny (2001) explain this phenomenon by saying that, in a given market at a given time, there are overvalued and undervalued companies. In this instance, the former bids to acquire the latter. The bid depresses the acquirer's valuation but also keeps this overvalued firm from falling too far or too fast when investors realise that the company is overvalued. AOL's acquisition of Time Warner was a case in point. The merger wave ends when there are no more undervalued firms left, because they have all been bought up (end of the 1980s) or because there are no more overvalued firms (2001, 2003).

Putting the purely financial elements aside, the determinants of mergers and acquisitions can be macroeconomic, microeconomic or human factors, as we will now see.

2/MACROECONOMIC FACTORS

Periods of innovation and technological change are often followed by merger waves. During the innovation period (computers in the 1970s, Internet today), many new companies are founded. Inevitably, however, the growth outlook for the growth and survival of

these startups fades, leading to a period of consolidation (Microsoft trying to buy Yahoo!). Moreover, startups' heavy financing needs may prompt them to seek the support of a major group that, in turn, can take advantage of the growth in the startups' business (Google buys You Tube). Many companies are undergoing a change in market scope. Thirty years ago, their market was national; now they find they must operate in a regional (European) or more often worldwide context (Arcelor Mittal is an example). Adapting to this change requires massive investment in both physical and human capital, leading to much higher financing needs (pharmaceuticals). Lastly, as competition increases, companies that have not yet merged must grow rapidly in order to keep up with their now larger rivals. Critical mass becomes important (e.g. Tabacalera–Seita and then Altadis–Imperial Tobacco).

Legislative changes have fostered restructuring in many industries. A broad trend towards deregulation began in the 1980s in the US and the UK, profoundly changing many sectors of the economy, from air transport to financial services to telecommunications. In Europe, a single market is being implemented in conjunction with a policy of deregulation in banking, energy and telecommunications. European governments further scale back their presence in the economy by privatising many publicly-held companies. In many cases, these companies then became active participants in mergers and acquisitions (Suez, ENI, Edf, Deutsche Telekom).

The increasing importance of financial markets has played a fundamental role in corporate restructuring. In the space of 30 years, European economies have evolved from primarily credit-based systems, where banks were the main suppliers of funds, to financial market systems, characterised by disintermediation (see Chapter 15). Not surprisingly, this change happened in conjunction with a shift in power from banks and other financial companies (Paribas, Mediobanca, Deutsche Bank, etc.) to investors. Accordingly, shareholders are exerting pressure on corporate managers to produce returns in line with their' expectations:

- in the event of disappointing performance, shareholders can sell their shares and, in doing this, they depress the share price. Ultimately, this can lead to a restructuring (Daimler Chrysler) or a takeover (ABN Amro, Telecom Italia);
- conversely, companies must convince the market that their acquisitions (Saint Gobain/BPB) are economically justified.

In conclusion, the financial and regulatory environment is a determining factor in economic consolidation. Industrial and technological changes naturally prompt companies to merge with each other. The decline in real growth in Europe has made it more difficult for firms to grow organically. In response, managers in search of new growth drivers try to combine with another company.

3/MICROECONOMIC FACTORS

By increasing their size and production volumes, companies reduce their unit costs. Long ago, BCG found that when cumulative production volume for manufacturing companies doubles, the unit price declines by around 20%. On this basis, an acquisition constitutes a shortcut to economies of scale, in particular in R&D, administrative or distribution costs (Pernod Ricard/Allied Domecq). Moreover, higher volume puts a company in a better position to negotiate lower costs with its suppliers or higher price with its customers (Vale/Inco).

Mergers can increase a company's market share and boost its revenues dramatically. To the extent the companies address complementary markets, merging will enable them to broaden their overall scope. Complementarity comes in two forms:

- geographic (Arcelor–Mittal). The two groups benefit from their respective presence in different regions;
- product (JP Morgan–Chase). The group can offer a full palette of services to its customers, ranging from traditional financing to investment banking services.

Although riskier than organic growth, mergers and acquisitions allow a company to save valuable time. In growing sectors of the economy, speed – the first mover advantage – is often a critical success factor. Once the sector matures, it becomes more difficult and more expensive to chip away at competitors' market shares, so acquisitions become a matter of choice (Gallaher–Japan Tobacco). When a company is expanding internationally or entering a new business, acquiring an existing company is a way to circumvent barriers to entry, both in terms of market recognition (L'Oréal–The Body Shop) and expertise (Google–Double-Click).

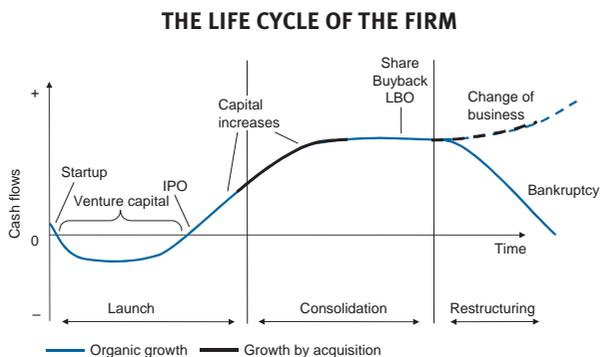
By gaining additional stature, a company can more easily take new risks in a worldwide environment. The transition from a domestic market focus to worldwide competition requires that companies invest much more. The financial and human risks become too great for a medium-sized company (oil and gas exploration, pharmaceutical research). An acquisition instantly boosts the company's financial resources and reduces risk, facilitating decisions about the company's future.

The need for cash, either because groups are in difficulties (Hertz sold by Ford) or because they regularly need to make capital gains (LBO funds), is another reason why M&A deals happen.

4/ HUMAN FACTORS

In addition to the economic criteria prompting companies to merge, there is also the human factor. Many companies founded between 1945 and 1970, which were often controlled by a single shareholder-manager, are now encountering, not surprisingly, problems of succession. In some cases, another family member takes over (Swatch, Fiat). In other cases, the company must be sold if it is to survive (Yves Saint-Laurent).

5/ THE LARGER CONTEXT



Mergers and acquisitions, although tricky to manage, are part of the life cycle of a company and are a useful growth tool.

Mergers are no panacea, however. Approximately one out of two fail because the promised synergies never materialise.

Synergies are often overestimated, their cost and time to implement underestimated. For example, making information systems compatible or restructuring staff can be notoriously difficult.

Numerous research works have measured the value created by an M&A deal and how this value is shared between shareholders of the buyer and of the target. They demonstrate that value is created for the target's shareholders because of the control premium paid. For the buyer's shareholders, the results are more mixed, even if they tend to show a recent improvement compared to the end of the 1990s where it was widely assumed that two-thirds of mergers were failing. Without some resounding failures (acquisition of Chrysler by Daimler¹ or the AOL–Time Warner merger) which heavily bias the results, M&A deals would appear value creative because of some largely successful deals such as Santander–Abbey National, Air France–KLM, NBC–Universal. Quality and speediness of the integration process are the key factors for successful M&A deals.

¹ *The share price of Daimler was divided by 3 between the acquisition of Chrysler and its sale in 2007.*

Section 42.2

CHOOSING A NEGOTIATING STRATEGY

A negotiating strategy aims at achieving a price objective set in accordance with the financial value derived from our valuation work presented in Chapter 32. But price is not everything. The seller might also want to limit the guarantees he grants, retain managerial control, ensure that his employees' future is safe, etc.

Depending on the number of potential acquirers, the necessary degree of confidentiality, the timing and the seller's demands, there is a wide range of possible negotiating strategies. We present below the two extremes: private negotiation and auction. Academic researchers² have established that none of these strategies is better than another. Our personal experience tell us the same thing: the context dictates the choice of a strategy.

² *See Boone and Mulherin (2007).*

1/ PRIVATE NEGOTIATION

The seller or his advisor contacts a small number of potential acquirers to gauge their interest. After signing a confidentiality agreement, the potential acquirers might receive an information memorandum describing the company's industrial, financial and human resource elements. Discussions then begin. It is important that each potential acquirer believe he is not alone, even if in reality he is. In principle, this technique requires extreme confidentiality. Psychological rather than practical barriers to the transaction necessitate the high degree of confidentiality.

To preserve confidentiality, the seller often prefers to hire a specialist, most often an investment banker, to find potential acquirers and keep all discussions under wraps. Such specialists are usually paid a success fee that can be proportional to the size of the transaction. Strictly speaking, there are no typical negotiating procedures. Every transaction is different. The only absolute rule about negotiating strategies is that the negotiator must have a strategy.

The advantage of private negotiation is a high level of confidentiality. In many cases, there is no paper trail at all.

The discussion focuses on:

- how much control the seller will give up (and the status of any remaining minority shareholders);
- the price;
- the payment terms;
- any conditions precedent;
- representations and warranties; and
- any contractual relationship that might remain between the seller and the target company after the transaction.

As you might expect, price remains the essential question in the negotiating process. Everything that might have been said during the course of the negotiations falls away, leaving one all-important parameter: price. We now take a look at the various agreements and clauses that play a role in private negotiation.

(a) Memorandum of understanding (MOU) or letter of intent (LOI)

When a framework for the negotiations has been defined, a memorandum of understanding is often signed to open the way to a transaction. A memorandum of understanding is a moral, not a legal, obligation. Often, once the MOU signed, the management of the acquiring company presents it to its board of directors to obtain permission to pursue the negotiations.

The memorandum of understanding is not useful when each party has made a firm commitment to negotiate. In this case, a memorandum of understanding slows down the process rather than accelerating it.

(b) Agreement in principle

The next step might be an agreement in principle, spelling out the terms and conditions of the sale. The commitments of each party are irrevocable, unless there are conditions precedent such as approval of the regulatory authorities. The agreement in principle can take many forms.

(c) Financial sweeteners

In many cases, specific financial arrangements are needed to get over psychological, tax, legal or financial barriers. These arrangements do not change the value of the company.

These arrangements cannot transform a bad transaction into a good one. They serve only to bring the parties to the transaction closer together.

Sometimes, for psychological reasons, the seller refuses to go below some purely symbolic value. If he draws a line in the sand at 200, for example, whereas the buyer does not want to pay more than 190, a schedule spreading out payments over time sometimes does the trick. The seller will receive 100 this year and 100 next year. This is 190.9 if discounted at 10%, but it is still 200 to his way of thinking. Recognise that we are out of the realm of finance here and into the confines of psychology, and that this arrangement fools only those who . . . want to be fooled.

This type of financial arrangement is window-dressing to hide the real price. Often companies build elaborate structures in the early stages of negotiation, only to simplify them little by little as they get used to the idea of buying or selling the company. Far from being a magical solution, such sweeteners give each party time to gravitate towards the other. In these cases it is only a stage, albeit a necessary one.

The following techniques are part of the investment banker's stock in trade:

- set up a special-purpose holding company to buy the company, lever up the company with debt, then have the seller reinvest part of the funds in the hope of obtaining a second gain (this is an LBO³ see Chapter 44);
- have the buyer pay for part of the purchase price in shares, which can then be sold in the market if the buyer's shares are listed;
- pay for part of the purchase price with IOUs;
- link part of the purchase price to the sale price of a nonstrategic asset the buyer does not wish to keep;
- an earnout clause, which links part of the transaction price to the acquired company's future financial performance. The clause can take one of two forms:
 - either the buyer takes full control of the target company at a minimum price, which can only be revised upwards; or
 - he buys a portion of the company at a fixed price and the rest at a future date, with the price dependent on the company's future profits. The index can be a multiple of EBIT, EBITDA or pre-tax profit.

3 Leveraged Buy Out.

Earnout provisions are very common in transactions involving service companies (advertising agencies, investment banks), where people are key assets. Deferral of part of the price will entice them to stay and facilitate the integration process.

2/AUCTION

In an auction, the company is offered for sale under a predetermined schedule to several potential buyers who are competing with each other. The objective is to choose the one offering the highest price. An auction is often private, but it can also be announced in the press or by a court decision.

Private auctions are run by an investment bank in the following manner. Once the decision is taken to sell the company the seller ask an audit firm to produce a Vendor Due Diligence (VDD), also called a Long Form Report, to provide a clear view of the weak points of the asset from legal, tax, accounting, regulatory, . . . points of view. The VDD is will be communicated to buyers later on in the process. For the moment, a brief summary of the company is prepared (a "teaser"). It is sent, together with a nondisclosure agreement, to a large number of potentially-interested companies and financial investors.

In the next stage (often called "Phase I"), once the potential buyers sign the nondisclosure agreement,⁴ they receive additional information, gathered in an information memorandum. Then they submit a nonbinding offer indicating the price, its financing, any conditions precedent and eventually their intentions regarding the future strategy for the target company.

At that point of time ("Phase II") either:

- a "short list" of up to half a dozen candidates at most is drawn up. They receive still more information and possibly a schedule of visits to the company's industrial sites

4 Implying they will use the information disclosed during the selling process only to make an offer and will not tell a third party they are studying this acquisition.

A well-processed auction can take 3–5 months between intention to sell and the closing. It is sometimes shorter when an investment fund sells one to another fund.

3/ THE OUTCOME OF NEGOTIATIONS

In the end, whatever negotiating method was used, the seller is left with a single potential buyer who can then impose certain conditions. Should the negotiations fall apart at this stage, it could spell trouble for the seller because he would have to go back to the other potential buyers, hat in hand. So the seller is in a position of weakness when it comes to finalising the negotiations. The principal remaining element is the representations and warranties clause.

Representations and warranties (“reps & warranties”) are particularly important because they give confidence to the buyer that the profitability of the company has not been misrepresented. It is a way of securing the value of assets and liabilities of the target company as the contract does not provide a detailed valuation.

Representations and warranties are not intended to protect the buyer against an over-valuation of the company. They are intended to certify that **all of the means of production are indeed under the company’s control and that there are no hidden liabilities**.

Well-worded representations and warranties clauses should guarantee to the buyer:

- the substance of fixed assets (and not their value);
- the real nature and the value of inventories (assuming that the buyer and the seller have agreed on a valuation method);
- the real nature of other elements of working capital;
- the amount and nature of all of the company’s other commitments, whether they are on the balance sheet (such as debts) or not.

The representations and warranties clause is generally divided into two parts.

In the first part (representations), the seller makes commitments related to the **substance** of the company that is to be sold.

The seller generally states that the target company and its subsidiaries are properly registered, that all the fixed assets on the balance sheet, including brands and patents, or used by the company in the ordinary course of business actually exist. As such, representations and warranties do not guarantee the book value of the fixed assets, but their existence.

The seller declares that inventories have been booked in accordance with industry standards and the demands of the tax authorities, that depreciation and provisions have been calculated according to GAAP.⁷ The seller declares that the company is up to date in tax payments, salaries and other accruals and that there are no prejudicial contracts with suppliers, customers, or employees. All elements already communicated to the buyer, in particular exceptional items such as special contracts, guarantees, etc., are annexed to the clause and excluded from it because the buyer is already aware of them.

Lastly, the seller guarantees that during the transitional period – i.e. between the last statement date and the sale date – the company was managed in a prudent manner. In particular, he certifies that no dividends were distributed or assets sold, except for those agreed with the buyer during the period, that no investments in excess of a certain amount were undertaken, nor contracts altered, etc.

⁷ Generally Accepted Accounting Principles.

In the second part of the clause (warranties), the seller guarantees the amount of the company's equity capital as of the most recent statement date (statements annexed to the agreement). The seller agrees to indemnify the buyer against any decrease caused by events that took place prior to the sale date. The guarantee remains in effect for a given period of time and is capped at a specified amount. This clause is often accompanied by a holdback (part of the purchase price is put in an escrow account) or a bank guarantee.

The representations and warranties clauses are the main addition to the sale agreement but, depending on the agreement, there may be many other additions, so long as they are legally valid – i.e. not contrary to company law, tax law, or stock market regulations requiring equal treatment of all shareholders. A non exhaustive list would include:

- means of payment;
- status and future role of managers and executives;
- agreements with majority shareholders;
- audit of the company's books. On this score, we recommend against realising an audit before the two parties have reached an agreement. An audit often detects problems in the company, poisoning the atmosphere, and can serve as a pretext to abandon the transaction.

Of course, the parties to the contracts should also call upon legal experts to ensure that each clause is legally enforceable.

The final step is the actual consummation of the deal. It often takes place at a later date, because certain conditions must be met first: accounting, legal or tax audit, restructuring, approval of domestic or foreign competition commissioners, etc.

4/ THE DUAL TRACK PROCESS

In order to improve its negotiation position or because the likely outcome of the sale process is unclear, the seller may decide to pursue a dual track process: it will launch a sale process and the preparation of an IPO in parallel. At the latest possible moment,⁸ it will choose to sell to the one offering the best price, be it the stock market or a buyer.

8 Even the day before the IPO takes place, as Eurazéo did when it sold Fraikin to CVC.

Section 42.3

TAKING OVER A LISTED COMPANY

For a public company, the negotiation cannot take place between two parties in the same way as for a private company. The transaction has to include minority shareholders.

Local regulations aim at protecting minority shareholders in order to develop financial markets. The main target of these regulations is to guarantee a transparent and equal treatment for all shareholders.

In order to acquire a listed company, the buyer needs to secure shares from a large number of minority shareholders. It would be too difficult and time-consuming to acquire shares on the open market; therefore the buyer usually makes a public offer (takeover bid) to all shareholders to buy their shares.

Each country has regulations governing takeovers of companies listed on domestic stock exchanges. The degree of constraints varies from one country to another.

1/STAKE-BUILDING

To succeed in acquiring a listed company the first step can be to start building a block in the company. This can be done on the open market by buying shares.

In order to prevent the acquirer from taking control of a company in that way, most market regulations require investors in a listed company to publicly declare when they pass certain thresholds in the capital of a company. If the acquirer fails to declare these shares, voting rights would be lost.

The first threshold is most often 5% (USA, France, Germany, Poland, Spain, . . .).

Regulatory disclosure requirements allow minority shareholders to monitor stake-building and prevent an acquirer from getting control of a company little by little. These requirements are also helpful for the management to monitor the shareholder structure of the company. By-laws can set additional thresholds to be declared (generally lower thresholds than required by law).

Regulatory threshold disclosure requirements are the following:

China	5% and multiples of 5% above
France	5%, 10%, 20%, 33.33%, 50% (cannot be below 0.5% in by-laws)
Germany	3%, 5%, 10%, 15%, 20%, 25%, 30%, 50%, 75%
India	5%, 10%, 14%, 54%, 74%
Italy	2%, 5%, 7.5%, 10%, and multiples of 5% above
Netherlands	5%, 10%, 15%, 20%, 25%, 30%, 40%, 50%, 60%, and 95%
Spain	5% and multiples (cannot be below 3% in by-laws)
Switzerland	5%, 10%, 20%, 33.3%, 50%, 66.6%
UK	3% and multiples of 1% above
US	5%

2/TYPE OF OFFER

It is very unusual for an acquirer to gain control of a public company without launching a public offer on the target. Such offers are made to all shareholders over a certain period of time (2–10 weeks depending on the country). Public offers can be split between:

- share offers or cash offers;
- voluntary or mandatory offers;
- hostile or recommended offers.

(a) Cash or share offers

The table below summarises the criteria relevant for assessing whether a bidder wants to propose shares or cash in a public offer:

	Payment in cash	Payment in shares	Comments
Signal from buyer's point of view	Positive: buyer's stock is undervalued. Debt financing: positive signal	Negative: buyer's stock is overvalued	
Signal from seller's point of view	None	Positive: the seller is taking some of the risk of the deal	
Allocation of synergies	Target company's shareholders benefit from synergies only via the premium they receive	Target company's shareholders participate fully in future synergies	In a friendly share exchange offer, the premium might be minimal if the expected synergies are high
Psychological effects	Cash lends credibility to the bid and increases its psychological value	Payment in shares has a "friendly" character	
Purchaser's financial structure	Increases gearing	Decreases gearing	The size of the deal sometimes requires payment in shares
Impact on purchaser's share price	After the impact of the announcement, no direct link between the purchaser's and target's share price	Immediate link between purchaser's and target's share price, maintained throughout the bid period	A share exchange offer gains credibility when the two companies' share prices align with the announced exchange ratio.
Shareholder structure	No impact unless the deal is later on refinanced through a share issue	Shareholders of the target become shareholders of the enlarged group	Sometimes, shareholders of the target get control of the new group in a share for share offer
Accounting effects	Increases EPS and its growth rate if the inverse of the target's P/E including any premium is greater than the after-tax cost of debt of the acquirer	Increases EPS if the purchaser's P/E is higher than the target's, premium included	EPS is not a real indicator of value creation, see Chapter 19
Purchaser's tax situation	Interest expense deductible	No impact, except capital gain if treasury shares are used	Taxation is not a determining factor
Seller's tax situation	Taxable gain	Gain on sale can be carried forward	
Index weighting	No change	Higher weighting in index (greater market capitalisation)	In the case of a share exchange, possible rerating owing to size effect

In practice, the choice is not so black and white. The purchaser can offer a combination of cash and shares (mix offers), cash as an alternative to shares, or contingent value rights. The purchaser's investment banker plays a key role in helping to choose the type of bid, the premium offered, how the bid is communicated to investors, etc.

(b) Hostile or recommended offers

The success or failure of an offer can largely depend on the attitude of the target's management and the board of directors towards the offer.

To maximise the chances of success, the terms of an offer are generally negotiated with the management prior to the announcement, and then recommended by the board of the company. The offer is then qualified friendly or recommended.

In some cases, the management of the target is not aware of the launch of an offer; it is then called an unsolicited offer. Facing this sudden event the board has to convene and to decide whether the offer is acceptable or not. If the board rejects the offer, it becomes hostile. This does not mean that the offer will not succeed but just that the bidder will have to fight management and the current board of directors during the offer period to convince shareholders.

(c) Voluntary or mandatory offers

The concept of the mandatory offer does not exist in every country. Nevertheless, in most countries, when a buyer passes a certain threshold or acquires the control of the target, she is required by stock exchange regulation to offer to buyback all the shareholders' shares. It is one of the founding rules of stock exchange regulations. It should be noted that in the US, there is no mandatory offer and an acquirer can buy a majority of the capital of a listed company without having to launch an offer to the minority shareholders.

Generally, the constraints for a mandatory offer are tighter than for a voluntary offer. For example, in the UK the mandatory offer will be in cash or at least a cash alternative will be provided. Obviously the conditions of the offer that the acquirer is allowed to set in a mandatory offer are limited because they are defined by the regulations.

3/ CERTAINTY OF THE OFFER

It would be very disruptive for the market if an acquirer were to launch an offer and withdraw it a few days later. All market regulations try to ensure that when a public offer is launched, shareholders are actually given the opportunity to tender their shares.

Therefore market regulation requires that the offer is funded when it is launched. Full funding ensures that the market does not run the risk of a buyer falling short of financing when the offer is a success! This funding usually takes the form of a guarantee by a bank (generally the bank presenting the offer commits that if the acquirer does not have the funds the bank will pay for the shares).

Another principle is that offers should be unconditional. In particular, the bidder cannot set conditions to the execution of the offer that remains in his hands (as an example, an offer can not be conditional upon board approval of the acquirer). Nevertheless, in most countries, the offer can be subject to a minimum acceptance (which generally cannot be too high) and regulatory approvals (including anti-trust). In a few countries (the UK, the Netherlands, the US), the offer can be subject to a material adverse change clause which can only be involved in extreme cases.⁹

9 In a UK takeover bid situation 9/11 was not deemed to be such a case.

4/ DOCUMENTATION AND MARKET AUTHORITY ROLE

The main role of market authorities is to guarantee the equal treatment of all shareholders and the transparency of the process.

In that regard, market authorities will have a key role in public offers:

- They set (and often control) the standard content of the offer document. This document must contain all relevant information allowing the target's shareholders to take a proper decision.
- They supervise the process timetable.
- In most countries their green light is necessary to the launch of the offer (they therefore control the price offered).

5/ DEFENSIVE MEASURES

In theory, a company whose shares are being secretly bought up on the stock market generally has a greater variety and number of defensive measures available to it than a company that is the target of a takeover bid. The reason behind this disparity is the secrecy surrounding shares bought up on the market compared with rules of equality and transparency applied to takeover bids.

If a company becomes aware that its shares are being bought up on the market, it is entitled to invoke all of the means of shareholder control described in Chapter 41. It can also get "friendly" investors to buy up its shares in order to increase the percentage of shares held by "friends" and push up its share price, thus making it more expensive for the hostile party to buy as many shares as it needs. Of course the company will also need to have the time required to carry out all of these operations, which generally involve waiting periods.

In the case of a takeover bid, there are fewer defensive measures available and they also depend on regulations in force in each country. In some countries (the UK and the Netherlands), all defensive measures taken during a takeover period (excluding attempts to identify other bidders) must be ratified by an EGM held during the offer period. Proxies granted by the general meeting of shareholders to the board prior to the offer period may be suspended. In some countries, any decision taken by the corporate and management bodies before the offer period that has not been fully or partially implemented, which does not fall within the normal course of business and which is likely to cause the offer to fail, must be approved or confirmed by the general meeting of the target's shareholders.

Furthermore, in some countries, as soon as the takeover bid has been launched, the parties involved are required to ensure that the interests of the target's employees are taken into account, to ensure that all shareholders are treated equally and that no upheaval on the stock markets is caused, to act in good faith and to comply with all regulations governing takeover bids.

Generally, a company has limited means for defending itself against takeover bids.

The target company can either defend itself by embarking on an information campaign, explaining to shareholders and to the media how it will be able to create greater value in the future than the premium being offered by the predator, or it can use more active defensive measures, such as:

- finding a third party ready to launch a competing takeover bid;
- launching its own takeover bid on the hostile bidder;
- getting “friends” to buy up its shares;
- carrying out a capital increase and changing the scope of consolidation of the company;
- poison pills;
- legal action.

If the hostile bidder attempts to neutralise some of these defensive measures during the offer period, the company will have to hold an EGM to authorise them. This can be a difficult process. Some shareholders may have already sold their shares to hedge funds that are betting on the success of the takeover bid, and will thus vote against the defensive measures. Others may fear that the defensive measures will be too effective and will wipe out the takeover premium.

A **competing takeover bid** must be filed a few days before the close of the initial bid. The price offered should be at least a few percentage points higher than the initial bid. There's always the possibility that the initial bidder will make a higher bid, so there's no guarantee that the competing offer will succeed. Likewise, the “**white knight**” can sometimes turn grey or black when the rescue offer actually succeeds. We saw this when the German group E.On came to the “rescue” of Endesa that was “under attack” by the Spanish group Gas Natural¹⁰ and when Alcan fell into the arms of Rio Tinto.

A **share purchase or exchange offer by the target on the hostile bidder, known as a Pac-Man defence**, is only possible if the hostile bidder itself is listed and if its shares are widely held. In such cases, industrial projects are not that different given that an offer by *X* on *Y* results in the same economic whole as an offer by *Y* on *X*. This marks the start of a communications war (advertisements, press releases, meetings with investors), with each camp explaining why it would be better placed to manage the new whole than the other.

The **buying up of shares by “friends”** is often highly regulated and generally has to be declared to the market authority which monitors any acting in concert or which may force the “friend” to file a counter offer!

¹⁰ Before it was pipped to the post by Enel and Acciona.

A capital increase or the issue of marketable securities is often only possible if this has been authorised by the general meeting of shareholders prior to the takeover bid, because generally there won't be enough time to convene an EGM to fit in with the offer timetable. In any event, a reserved issue is often not allowed.

Poison pills, described on p. 853, are a strong dissuasive element. The negative consequences of warrants being issued for the company launching a hostile takeover bid mean that it is generally prepared to negotiate with the target – neutralisation of the warrants in exchange for a higher offer price.

US experience has shown that poison pills strengthen the negotiating position of the target's management, although they don't ensure its independence. If warrants are in fact issued, the matter of director responsibility will be raised, since the directors will effectively have caused shareholders to lose out on an opportunity to get a higher price for their shares.

Legal action could be taken to ensure that market regulations are complied with or on the basis of misleading information if the prospectus issued by the hostile bidder appears to criticise the target's management. There is also the possibility of reporting the hostile bidder for abuse of a dominant position or insider trading if unusual trades are made before the offer is launched, for failing to comply with the principle of equality of shareholders or for failing to protect the interests of employees if the target has made risky acquisitions during the offer period. The real aim of any legal proceedings is to gain time for the target's management given that, in general, it takes a few months for the courts to issue rulings on the facts of a case.

6/THE LARGER CONTEXT

The various anti-takeover measures generally force the bidder to sweeten his offer, but rarely to abandon it. What can happen is that an initially hostile bid can turn into a friendly merger (Imperial Tobacco–Altadis, RBS-Santander-Fortis–ABN Amro). Whether a hostile offer is successful or a white knight comes to the rescue, events invariably lead to the loss of the target company's independence.

Which, then, are the most effective defensive measures? In recent bids involving large companies, those that have taken the initiative far upstream have been at a clear advantage. A good defence involves ensuring that the company is always in a position to seize opportunities, to anticipate danger and to operate from a position of strength so as to be able to counterattack if needs be.

In our view, loyal shareholders can be the best defence. What makes them loyal? Good financial performance, candid financial communication, a share price that reflects the company's value, and skilled managers who respect the principles of shareholder value and corporate governance.

7/SUMMARY OF SOME NATIONAL REGULATIONS

The table below summarises the principal rules applicable to takeover bids in some countries:

Country	Regulator	Threshold for mandatory bid	Minimum percentage mandatory bid must encompass	Bid conditions allowed?	Bid validity after approval	Squeeze-out ¹¹ possible?
China	China Securities Regulatory Commission www.csrc.gov.cn	30%	5%		30 days	No. Minority shareholders have the right to sell to the buyer after an offer giving him at least 75% of shares, at the offer price
France	AMF, Autorité des Marchés Financiers www.amf-france.org	33.3% of shares or voting rights, 2% p.a. between 33.3% and 50% of shares or voting rights	100% of shares and equity-linked securities	Usual suspects ¹² None if bid mandatory	25–35 trading days	Yes if > 95% of voting rights and shares
Germany	BAFin, Bundesanstalt für Finanzdienstleistungsaufsicht www.bafin.de	30% of voting rights	100%	Usual suspects ¹² None if mandatory bid	4–10 weeks	Yes, if > 95% of shares
India	Security and Exchange Board of India www.sebi.gov.in	15% of shares or voting rights	20% at least	Minimum acceptance	20 days	No
Italy	CONSOB, Commissione Nazionale per le Società e la Borsa www.consob.it	30% of shares, 3% p.a. beyond 30%	100% of voting shares	Usual suspects ¹²	15–25 trading days	Yes, if > 95% of voting rights and shares
Netherlands	AFM, Autoriteit Financiële Markten www.afm.nl	30% of voting rights	100% of shares and equity-linked securities	Minimum acceptance	> 23 trading days and > 30 if hostile	Yes if > 95%

Spain	CNMV, Comisión Nacional de los Mercados de Valores www.cnmv.es	30% and 50% or less if right to nominate more than half of the directors or any increase of 5% between 30% and 50%	100%	Usual suspects ¹²	4–11 weeks	Yes if > 90% of the voting rights
Switzerland	COPA, Commission des Offres Publiques d'Achat www. takeover.ch	33.3% of voting rights ¹³	100% of shares	Usual suspects ¹²	20–40 trading days	Yes, if > 98% of voting rights
UK	Takeover Panel www. thetakeover- panel.org.uk	30% of voting rights and any increase above	100% of shares and all instruments convertible or exchangeable into shares	Usual suspects ¹² and MAC clause that must be approved by regulator	Less than 60 trading days	Yes, if > 90% of the shares
USA	SEC, Security Exchange Commission www.sec.gov	None	None	Usual suspects ¹² and MAC clause	> 20 trading days	Yes with normal or super majority

¹¹ That is a possibility for the majority shareholder to force the buyback of minority shareholders and delist the company if minority shareholders represent only a small part of the capital.

¹² Minimum acceptance, antitrust authorisations, authorisation of shareholders to issue shares.

¹³ Or a threshold up to 49% if the by-laws of the target company permit.

8/ EUROPEAN DIRECTIVE ON PUBLIC OFFERS

The popularity of cross-border takeovers has led the EU to issue a directive on public offers (on which it has been working for 15 years before it was finally voted in 2004).

The text is rather general in nature and leaves considerable flexibility for translation into national legislation.

The directive first sets forth some basic principles:

- Shareholders in the same category must be treated equally.
- Shareholders must have enough time and information to decide whether the takeover bid is well founded.
- Management of the target company must act in the interest of the company and allow shareholders the opportunity to make up their own minds on the takeover bid.
- Manipulation of share prices is naturally banned.
- A bid must have secured financing before being announced.
- The bid must not keep the target company from operating properly.

In addition to basic principles, the directive sets precise rules in certain areas. Here are the main subjects:

- the principle of a mandatory takeover bid;
- anti-takeover defences;
- the principle of mandatory buyout and mandatory squeezeout;
- available information;
- takeover law.

(a) Mandatory takeover bids

The directive lays down the principle that a shareholder who has assumed effective control over a company must bid for all equity-linked securities. It is up to individual countries to set a threshold of voting rights that constitutes effective control.

The directive states very specifically the floor price of a mandatory bid: the highest price paid by the new controlling shareholder in the 6–12 months prior to the bid (the exact period is set by national regulations).

A mandatory bid can be in either cash or shares (if the shares are listed and are liquid).

(b) Anti-takeover defences

The issue of limiting anti-takeover defences, poison pills and the like, has been more controversial. Some countries feared that, by limiting anti-takeover defences, Europe would be at a disadvantage to the US, which does allow such practices. Consequently, the European directive left European states free to:

- ban or not to ban the boards of target companies from taking anti-takeover defences during the bid, such as poison pills, massive issuing of shares, etc., without approval from an extraordinary general meeting;
- suspend or not to suspend during an offer, shareholder's agreements or articles of association limiting voting rights, transfers of shares, shares with multiple voting rights, rights of approval or of first refusal;
- authorise target to put in place anti-takeover measures without the approval of its shareholders if the buyer does not need a similar approval from its own shareholders to put in place similar measures at its own level.

Multiple voting rights and/or restrictions on voting rights disappear as of the first general shareholders' meeting after a bid that has given a bidder a qualified majority of the company. This does not apply to golden shares that have been deemed compatible with European law.¹⁴

¹⁴ *European law strictly limits national government leeway on golden shares. Golden shares are nonetheless still possible in some sectors and special cases, such as the defence industry.*

(c) Squeezeouts and mandatory buyouts

The directive lays down the principle of the right to make squeezeout offer by shareholders (up to national legislation to decide):

- having obtained at least 90% of a company's shares (individual countries have the option of raising the threshold to 95%); or
- having obtained at least 90% of the shares in the course of a bid for all the shares.

The price of a squeezeout can be the same as that of the mandatory bid or of a voluntary bid that has obtained more than 90% of the shares. In parallel, a minority of shareholders can ask for a buyout (in the same cases that allow a squeezeout).

M&A deals tend to come in waves. Their determinants are macroeconomic (globalisation, deregimentation, technological evolutions), microeconomic (search for size, for new markets, gains of time) or human (succession issues).

The art of negotiation consists of allocating the value of the synergies expected from a merger or acquisition between the buyer and the seller. There are two basic methods of conducting the negotiations:

- private negotiation, which preserves a high level of confidentiality, while excluding offers that might have been received had the process been wider;
- a private auction, which heightens the competition between buyers, but is more restrictive for the seller.

Regardless of the chosen procedure, certain elements are common to every deal:

- memorandums of understanding and agreements in principle serve to describe the general agreement found between the parties and are a milestone along the path to full commitment of the parties to the deal;
- representations and warranties guarantee to the buyer that all of the means of production belong to the company and that there are no hidden liabilities; the seller certifies substantive aspects of the company and the amount of equity capital;
- in some cases, earnout clauses link a portion of the purchase price to the company's future profits.

Stake-building can be the first step to acquiring control over a listed company. But it can be slow and faces the requirement of declaring the crossing of thresholds.

A public offer is the usual way to acquire a listed company. It is based on two fundamental principles: transparency and equal treatment of shareholders. It can be in cash or in shares, hostile or friendly, voluntary or mandatory.

In each country, the acquisition of listed companies is conducted under the supervision of a stock market watchdog.

SUMMARY

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- 1/What are the advantages and drawbacks of private negotiation?
- 2/What are the advantages and drawbacks of a private sale by auction?
- 3/What is the advantage of a public purchase or share exchange offer for a minority shareholder?

QUESTIONS

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quiz](#)

- 4/What advantages does a public offer have for the acquirer over an acquisition on the market? What are the drawbacks?
- 5/Can a company launch an offer to buy another company that is for sale without having any real intention of closing the deal? Why? What protection is there for the seller?
- 6/What will be key to make an M&A deal a successful event in a company history?
- 7/Why are earnout clauses so popular with companies in the service sector?
- 8/All things being equal, what is the downside of a deal being kept highly confidential?
- 9/When is it a good idea to go for a private auction?
- 10/How can a buyer be protected against any hidden liabilities and debts that the target may have?
- 11/What is the purpose of representations and warranties? What are the limits of such clauses?
- 12/What is the logical result of a successful hostile buy-up of shares on the market?
- 13/What market authorities' concern is addressed by a suspension of trading after notice of an offer has been filed?
- 14/Why are defence mechanisms against hostile takeover bids very strictly regulated?
- 15/On the basis of financial theory, how can the role of an investment bank in a deal be summarised?

ANSWERS

- 1/*Advantage: negotiations are kept confidential. Drawback: potential candidates may be left out.*
- 2/*Advantage: organisation of a market. Drawback: lack of confidentiality.*
- 3/*The minority shareholder is protected as he will be able to sell his shares at the same price as the majority shareholder.*
- 4/*The acquirer does not cause the share price to rise. The drawback is that if a stock market battle unfolds, he will not be in such a good position.*
- 5/*Yes. To obtain information. Memorandums of understanding and of agreement, confidentiality agreements.*
- 6/*The integration process post acquisition.*
- 7/*The deal itself can have an unpredictable impact on human resources – the company's main assets.*
- 8/*The sale price might be lower.*
- 9/*When the business for sale is very profitable, and attractive to both trade buyers and financial investors.*
- 10/*General warranties.*
- 11/*It provides a guarantee for the assets and liabilities of the company. Under no circumstances can such a clause guarantee the fairness of the price paid for the business.*
- 12/*A takeover bid.*

- 13/ *The fair and equal dissemination of information.*
- 14/ *Anti-takeover measures can deprive shareholders of the capital gains that come out of the free process of auctions.*
- 15/ *Manage information asymmetry.*

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