

THE ART OF CAPITAL RESTRUCTURING

Creating Shareholder Value
Through Mergers and Acquisitions



H. Kent Baker and Halil Kiymaz, Editors

KOLB SERIES IN FINANCE

Essential Perspectives

THE ART OF CAPITAL RESTRUCTURING

Creating Shareholder
Value through Mergers
and Acquisitions

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藏书章

H. Kent Baker
Halil Kiymaz

The Robert W. Kolb Series in Finance



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CHAPTER 1

Mergers, Acquisitions, and Corporate Restructuring: An Overview

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INTRODUCTION

An important question in finance is whether managerial actions create market value or shareholder wealth. Neoclassical economic theory assumes that corporate management acts to maximize shareholder wealth. Studies involving mergers and acquisitions (M&As) directly examine this issue. Such studies, which are relevant to shareholders, managers, regulators, and other stakeholders, show considerable variation in their results. Thus, debate continues about both the short-term and long-term performance of M&As. As markets become more integrated, M&As continue to be a hot topic in both academia and the business world. Given the frequency of these activities, businesspeople need to understand why and how such activities take place.

Although sometimes used interchangeably or synonymously, the terms *merger* and *acquisition* mean slightly different things. A *merger* is a combination of two or more companies in which one company survives and the merged company goes out of existence. Unlike a merger, a *consolidation* is a business combination in which two or more companies join to form an entirely new firm. With an *acquisition*, one company takes controlling ownership interest in another firm, typically buying the selected assets or shares of the target company. On the surface, the distinction in meaning may not seem to matter because all of them are strategic transactions that usually change not only the control of a company but also its strategic direction. Depending on the transaction, the financial, legal, tax, and even cultural impact of a deal may differ substantially.

M&As represent a fast-paced and highly complex environment in which transactions provide unique opportunities with considerable risk. Worldwide M&A transactions involve trillions of dollars that can have a major impact on both domestic and global economies. M&As are a vital part of any healthy economy

because they force firms to use their resources efficiently and allow strong companies to grow and weaker companies to be swallowed. Further, M&As enable firms to achieve or maintain their competitive advantage by anticipating and adjusting to change. Through M&As a company can grow rapidly without having to create another business entity. Consequently, M&As represent a vital business tool and an alternative growth and expansion strategy for many companies. In short, an M&A is an instrument of macroeconomic renewal. Yet, these complex transactions are laden with potential problems and pitfalls. In fact, many M&A transactions fail to realize expected benefits. Understanding how to ensure the successful consummation of these transactions is critical to the goal of maximizing shareholder wealth.

PURPOSE OF THE BOOK

This book provides a fresh look at the current state of mergers, acquisitions, and corporate restructuring in both developed and emerging markets. Although M&As generally focus on corporate expansion, companies sometimes contract and downsize their operations. *Restructuring* refers to the act of partially dismantling or otherwise reorganizing a company for the purpose of making it more profitable. This book considers several different forms of physical restructuring such as divestitures as well as capital restructuring, which refers to alterations in the capital structure of the firm. This volume explains not only the financial aspects of these transactions but also legal, regulatory, tax, ethical, social, and behavioral considerations. In short, although economics plays an essential role in understanding M&A activity, psychology also plays a critical part. Thus, achieving "success" in any M&A effort is a combination of both art and science.

Additionally, the latest research on M&A-related topics permeates the book. The coverage extends from discussing basic concepts, motives, strategies, and valuation techniques to their application to increasingly complex and real-world situations. The book explains these methods from both a management and investor perspective while emphasizing the wealth effects on shareholders of these different strategies. Thus, this volume spans the gamut from theoretical to practical, while attempting to offer a useful balance of detailed and user-friendly coverage.

DISTINGUISHING FEATURES OF THE BOOK

Given the popularity and importance of mergers, acquisitions, divestitures, and other financial capital restructuring, the fact that many books deal with these topics is not surprising. Yet, most do not offer the scope of coverage and breadth of viewpoints contained in this volume. The book provides a comprehensive and current discussion of theoretical developments, empirical results, and practice involving M&As. Where possible, this volume avoids theoretical and mathematical derivations unless they are necessary to explain the topic. It attempts to distill the results of several hundred empirical studies in an understandable and clear manner.

The book has seven other distinguishing features.

1. The book attempts to blend the conceptual world of scholars with the pragmatic view of practitioners. This volume is not a “how to” book or a simple easy-to-use-guide but instead incorporates theory and practice. It also provides a synthesis of important and relevant research studies in a straightforward and pragmatic manner and includes recent developments.
2. The book contains contributions from more than 40 scholars and practitioners from around the world who are leading experts in their fields. Thus, the breadth of contributors ensures a variety of perspectives and a rich interplay of ideas.
3. This book emphasizes best practices that lead to M&A success. Such practices focus on valuing the target, negotiating and financing the deal, and engaging in postacquisition planning and integration.
4. The book offers a strategic focus to help provide an understanding of how these decisions can affect overall value. These strategies include both takeover and defensive strategies.
5. The book has a global focus rather than being U.S.-centric. It reviews research dealing with both U.S. firms and others from around the world. Special emphasis is placed on the cross-border effects involving developed and emerging markets.
6. The book examines both technical and human aspects of M&As. The technical aspects mainly deal with legal, regulatory, and valuation issues. By contrast, the human aspects deal with issues involving corporate governance, cultural due diligence, organization and human resources, and the behavioral effects.
7. Each chapter contains a set of discussion questions that helps to reinforce key aspects of the chapter’s content. A separate section near the end of the book contains guideline answers to each question.

INTENDED AUDIENCE FOR THE BOOK

The intended audience for this book includes academics, researchers, practitioners (e.g., business executives, managers, investment bankers, lawyers, and consultants), students, libraries, and others interested in mergers, acquisitions, and restructuring. Given its extensive coverage and focus on the theoretical and empirical literature, this book should be appealing to academics and researchers as a valuable resource. Practitioners can use this book to provide guidance in helping them navigate through these strategic transactions. This book should be appropriate as a stand-alone or supplementary book for advanced undergraduate and graduate business students as well as for management training programs in M&As. Finally, libraries should find this work to be suitable for reference purposes.

STRUCTURE OF THE BOOK

The remainder of this book consists of 28 chapters divided into six main parts. A brief synopsis of each part and chapter follows.

Part I. Background

This part contains six chapters (Chapters 2–7) that provide important background information that sets the stage for the remaining sections. The first three chapters focus on merger waves, takeover regulation, and corporate governance. Next, Chapters 5 and 6 examine ethical, social, and theoretical issues involving M&As. Chapter 7 focuses on the short-term and long-term performance of M&As.

Chapter 2 Merger Waves (Jarrod Harford)

The chapter surveys the vast literature on mergers with a focus on merger waves. The motives for mergers run the spectrum from a purely efficient reshuffling of assets to purely managerial driven empire-building strategies. Because merger activity clusters in time and within industries, an understanding of the causes of these merger waves is needed to comprehend the dominant motivations behind mergers. Research clearly establishes a link between aggregate economic activity, especially as reflected in the stock market, and aggregate merger activity. Further, research shows that technological, regulatory, and economic shocks to industries' operating environment, coupled with macro-level ease of financing, generate merger waves. While the primary driver of merger activity is economic efficiencies, room exists for other motives such as empire building. Nonetheless, the other motives do not dominate the activity.

Chapter 3 Takeover Regulation (Marina Martynova and Luc Renneboog)

Takeover regulation is a set of legal provisions aimed at facilitating efficient corporate restructuring, mitigating potential conflicts of interest among parties involved in the control change transaction, and protecting minority shareholders. This chapter reviews the major takeover regulation provisions present in different jurisdictions around the world that include the mandatory bid rule, principle of equal treatment of shareholders, squeeze-out and sell-out rules, ownership and control disclosure, board neutrality concerning the takeover bid, and restrictions regarding the use of takeover defense measures. The chapter shows that takeover regulation provisions vary substantially across jurisdictions, reflecting different priorities as to the goals regulators set relating to the development of the takeover market and corporate governance.

Chapter 4 Corporate Governance and M&As (Fei Xie)

This chapter surveys the body of research at the intersection of two broad literatures, corporate governance and M&As. Four major themes and findings emerge. First, M&As as a managerial disciplinary device and part of a comprehensive corporate governance system have powerful incentive effects on managers and valuation effects on shareholders and bondholders. Second, as major corporate investments, M&As generate higher returns for acquiring shareholders when acquiring managers operate in environments of better corporate governance. These environments are defined by exposure to threats of hostile takeovers, competition from the product market, effective monitoring by boards and institutional investors, a strong link between managerial wealth and performance, and the risk of financial distress and ceding control to creditors. Third, the target firm's corporate governance is also important as target shareholder gains are significantly higher

when the interests of target managers and shareholders are better aligned. Lastly, as a mechanism to allocate resources to their most efficient use, M&As generate synergistic gains and efficiency improvement that increase with the difference in corporate governance between acquiring and target firms.

Chapter 5 Ethical and Social Issues in M&As (Robert W. McGee)

The press, politicians, policy makers, and some economists often view M&As negatively, as something that must either be stopped or heavily regulated. Some perceive that workers are harmed by M&As, which is sometimes the case, while others view M&As as anticompetitive, which is often not the case. From a philosophical perspective, one might raise the question of whether such activity should be regulated at all if M&As do not violate anyone's rights. Yet, this question is seldom raised. This chapter examines some ethical issues that have been raised and applies several tools of ethical analysis in an attempt to determine which acts are ethical and which are not.

Chapter 6 Theoretical Issues on Mergers, Acquisitions, and Divestitures (Abdul H. Rahman)

Value-increasing motives for corporate takeovers may be categorized as creating operational efficiencies or allocative synergies, which can create market power. Empirical findings suggest that the former category dominates managers' motives. Value-decreasing motives are based on managers' private interests such as reduction of employment risk, managerial discretion driven by excess free cash flow, and managers' overconfidence or hubris. Evidence suggests that M&As occur in waves and across industries. The level of merger activity is also positively correlated with bull stock markets. Several models, including those based on chief executive officer envy and firm size, offer explanations for this evidence. Divestitures may be viewed as managerial actions to reverse or correct previous strategic decisions such as diversification, or to establish strategic positioning. As such, while takeovers expand the boundary of the firm, divestitures do the opposite. Sources of divestiture gains include the focus hypothesis where managers attempt to eliminate business units in different industries. Divestment may also reduce information asymmetry and hence lead to a more optimal pricing mechanism for both the parent firm and the spin-off business unit. Finally, divestiture gains may arise from negative synergies when the firm is overdiversified.

Chapter 7 The Short-Term and Long-Term Performance of M&As (Shantanu Dutta and Samir Saadi)

This chapter focuses on short-term stock return performance of target and acquiring firms and long-term stock return and operating performance of acquiring firms. Evidence shows that target shareholders generally earn significantly positive abnormal returns but the acquirers' shareholders earn, on average, a zero abnormal return at the acquisition's announcement. Considerable variation exists in these results. However, various studies with non-U.S. data consistently report significant and positive abnormal returns for acquirers' shareholders around the announcement date. A set of other studies investigates the long-term stock return performance of acquiring firms. Most of these long-term studies conclude that acquiring firms experience significant negative abnormal returns over a one- to

three-year period after the merger. Still, debate continues on this issue. Given a lack of consensus on market-based studies and counterintuitive results, a smaller but growing body of literature investigates the long-term operating performance of acquiring firms. Previous empirical studies in this area report mixed and inconsistent results.

Part II. Valuation

This part consists of four chapters (Chapters 8–11) dealing with valuation methods. Chapters 8 and 9 examine standard valuation methods and real options, respectively. Chapter 10 examines the adjustment needed for the implicit minority discount. Chapter 11 focuses on cross-border valuation effects in developed and emerging markets.

Chapter 8 Standard Valuation Methods for M&As (Pablo Fernandez)

This chapter describes the four main groups comprising the most widely used company valuation methods: (1) balance sheet-based methods, (2) income statement-based methods or multiples, (3) discounted cash flow methods, and (4) value creation methods using economic value added and economic profit. Conceptually correct methods are based on cash flow discounting. The chapter briefly discusses other methods that are conceptually incorrect but continue to be used in practice. The chapter also addresses the lack of agreement about ways of calculating the value of tax shields and the dispersion of the market risk premium used by professors and financial analysts.

Chapter 9 Real Options and Their Impact on M&As (Hemantha Herath and John S. Jahera Jr.)

The use of option analysis has grown from use with financial options to the application to real options. One specific application involves the M&A process. Almost all such transactions have embedded options that can address issues ranging from the specific terms of the M&A to the timing of the M&A decision and perhaps even the later divestiture decision. The impact of real options on M&A analysis is still developing as more managers acquire the knowledge to specifically value different decisions involved in a transaction. Traditional M&A analysis followed capital budgeting techniques such as net present value. Financial economists argue that such techniques are unable to capture value associated with managerial flexibility and other elements. As M&A activity has become more global, managers not only face greater complexity but also more alternative courses of action. Real options analysis represents another dimension to be incorporated into the decision to engage in M&A activity.

Chapter 10 The Law and Finance of Control Premia and Minority Discounts (Helen Bowers)

The adjustment for the implicit minority discount is a controversial element of Delaware court practice. The Delaware courts usually adjust the value of minority shares in appraisal action upward to reflect a perceived market inefficiency that results in a persistent undervaluation of equity relative to intrinsic value. The genesis of the implicit minority discount may arise from a misunderstanding of

the assertion that stock prices represent minority values. Although some view the adjustment for the implicit minority discount as possible minority compensation for the wealth misappropriated by the majority, a direct adjustment according to the facts of the case would lead to a more economically efficient and equitable outcome. Because the value of minority shares that is derived from comparable company analysis is a minority value only in the sense that it is the value of the equity in the absence of a controlling stockholder, the adjustment for implicit minority discount transfers wealth from the controlling stockholders to the minority.

Chapter 11 Cross-Border Valuation Effects in Developed and Emerging Markets (Wenjie Chen)

Cross-border M&As have become an integral part of the global business landscape. In 2007, the value of cross-border M&A transactions amounted to \$1,637 billion, which is a 21 percent increase from the previous record set in 2000. Historically, the majority of M&As have taken place between industrialized countries. In recent years, however, emerging markets started engaging in cross-border M&A activities. Developed and emerging markets have fundamental differences in institutions, legal environment, corporate governance, and factor endowments such as accessibility to relatively cheap labor. These differences have profound impacts on the participants in and outcomes of cross-border M&As. Studying these impacts is important in understanding the nature of cross-border M&As and their valuation effects on both target and acquiring firms.

Part III. The M&A Deal Process

Chapters 12–17 provide an overview of the M&A deal process. Chapters 12 and Chapter 13 offer a discussion on sources of financing and means of payments and cultural due diligence. Chapter 14 and 15 focus on the negotiation process. The final two chapters examine the postacquisition planning and integration process and issues related to organizational and human resources.

Chapter 12 Sources of Financing and Means of Payments in M&As (Marina Martynova and Luc Renneboog)

This chapter reviews the academic literature regarding an acquiring firm's choices of financing sources and the means of payment in corporate takeovers. The financing and payment decisions have a significant impact on the value of the acquiring firm. Investors take into account the information signaled by the choices of both the payment method and the sources of takeover financing when estimating the possible synergistic takeover value at the announcement. The financing decision is influenced by the acquirer's concerns about the cost of capital. In particular, in line with the pecking order hypothesis, cash-rich acquirers opt for the least expensive source of financing—internally generated funds. Acquirers operating in a better corporate governance environment benefit from lower costs of external capital. That is, debt financing is more likely when creditor rights are well protected by the law and court system, and the use of equity financing increases when shareholder rights protection is high. The takeover financing decision is closely related to the acquirer's strategic preferences for specific types of payment.

Chapter 13 Cultural Due Diligence (Ronald F. Piccolo and Mary Bardes)

The due diligence process associated with evaluating the viability of a merger, acquisition, or extended partnership most often comprises a comprehensive examination of strategic, economic, and financial metrics that estimate firm fit and expectations for economic return. Despite the vast amounts of hard data that characterize this process, a high failure rate remains for M&As, due in large part to conflicts in the merging firms' organizational cultures. Managers in the due diligence process often fail to make valid assessments of the norms, values, standards, and traditions of merging firms; neglect the influence of an organization's culture on the behavior and attitudes of its members; and underestimate the challenges associated with integrating two otherwise diverse firms. This chapter presents a brief description of organizational culture with some suggestions for measuring culture in an organizational setting.

Chapter 14 Negotiation Process, Bargaining Area, and Contingent Payments (William A. Grimm)

This chapter describes the negotiation process using two hypothetical situations involving a large, publicly held company as the buyer and two types of sellers—a small, publicly held company and a small, privately held company. The major issues that are usually involved in each type of transaction are discussed. The chapter emphasizes the thorough preparation needed for the negotiation by both the buyer and the seller and discusses how the preparation differs for each. It also discusses the interaction among the issues being negotiated, which makes clearly defining the bargaining area around the price to be paid difficult.

Chapter 15 Merger Negotiations: Takeover Process, Selling Procedure, and Deal Initiation (Nihat Aktas and Eric De Bodt)

Recent literature in finance reveals that the takeover market during the deal-friendly decade of the 1990s was much more competitive than prior research had indicated. The chapter provides an analysis of the private portion of the takeover process. The results show that about half of all targets are auctioned among multiple bidders, whereas the remainder negotiates with a single bidder. The chapter documents the takeover process of 1,774 large U.S. deals announced during the period from 1994 to 2007, of which 847 negotiations (48 percent) involved no explicit competition and 927 auctions (52 percent) had multiple bidders. An empirical analysis of the sales procedure's determinants reveals that, consistent with auction theory, auctions are more frequent for smaller targets (relative to the acquirer), less diversified targets, and cases in which the number of potential acquirers is large. Finally, the chapter discloses a relationship between deal initiation and the choice of the sales procedure; auctions represent the preferred method when the seller initiates the transaction.

Chapter 16 Postacquisition Planning and Integration (Olimpia Meglio and Arturo Capasso)

The purpose of this chapter is to provide an in-depth analysis of the postacquisition process, which involves both planning and implementation processes. The integration process is a crucial part in making a merger or acquisition successful. This process can result in synergy and capability transfers that can produce real benefits

for the combined entity. This process is vital to creating value and deserves careful planning and execution because it contains potential pitfalls that can be detrimental to postacquisition performance. The analysis in this chapter focuses on setting priorities according to acquisition goals, identifying the roles and competencies of the integration manager, developing reliable integration tools, and measuring acquisition performance.

***Chapter 17 Organizational and Human Resource Issues
in M&As (Siddhartha S. Brahma)***

Success in M&As cannot be assured because many of them fall short of their stated goals. Although the strategy and finance literature dominate this field, relatively little attention is given to the organizational and human resource aspects of M&As. This chapter reviews the literature on this subject and suggests that organizational and human resource issues play a crucial role in shaping the M&A outcome. The organizational perspective presents the literature on the organizational-fit and process school. The decision-making process and the cultural integration process constitute the two views of the process school. On the other hand, the human resource perspective covers the areas of employees' reaction, role of communication, social integration, postmerger identification, and organizational justice.

Part IV. Takeovers and Behavioral Effects

Chapters 18–21 provide an overview of takeover strategies and defensive takeover strategies in M&As. These chapters further discuss the impact of restructuring on bondholders and behavioral effects in M&As.

Chapter 18 Takeover Strategies (Shailendra Pandit)

Takeover strategies involve identifying potential takeover targets, determining the timing and terms of the offer, addressing competing bidders and target resistance, and navigating takeover negotiations to a successful conclusion. This chapter traces the antecedents of takeover strategies that include several external and internal factors such as macroeconomic and capital market conditions, taxes, regulatory environment, motivations of the involved firms, and potential competition from other firms. This material is followed by a discussion of specific forms of bidding approaches including the level of friendliness of the acquirer's approach, the form of compensation, and other contractual features that have consequences for the firms involved in both the acquisition and the actual outcome of the bid itself. Thus, the discussion in this chapter centers on the causes and effects of takeover strategies on acquirers.

***Chapter 19 Defensive Strategies in Takeovers
(Christian Rauch and Mark Wahrenburg)***

Over the past decades, defense mechanisms against hostile takeover attempts have become both more versatile and increasingly complex. As a reaction to more sophisticated takeover strategies, M&A consultants and their clients have developed a vast array of preventive and remedial defense strategies to deter potential hostile bidders and fend off actual bids from hostile acquirers. This chapter introduces the most common and frequently used antitakeover strategies, while focusing on the