Class / Week #2:

Discussion of Quiz #2

✓ Quiz #2, Q #1.

Net to shareholders = \$100 m ✓

Assumed of debt = \$200 m ✓

Depr. Book Value of Purchased Asset = \$50 M

Purchase Price

$= [100 + 200] - 50$

$= 250$ m

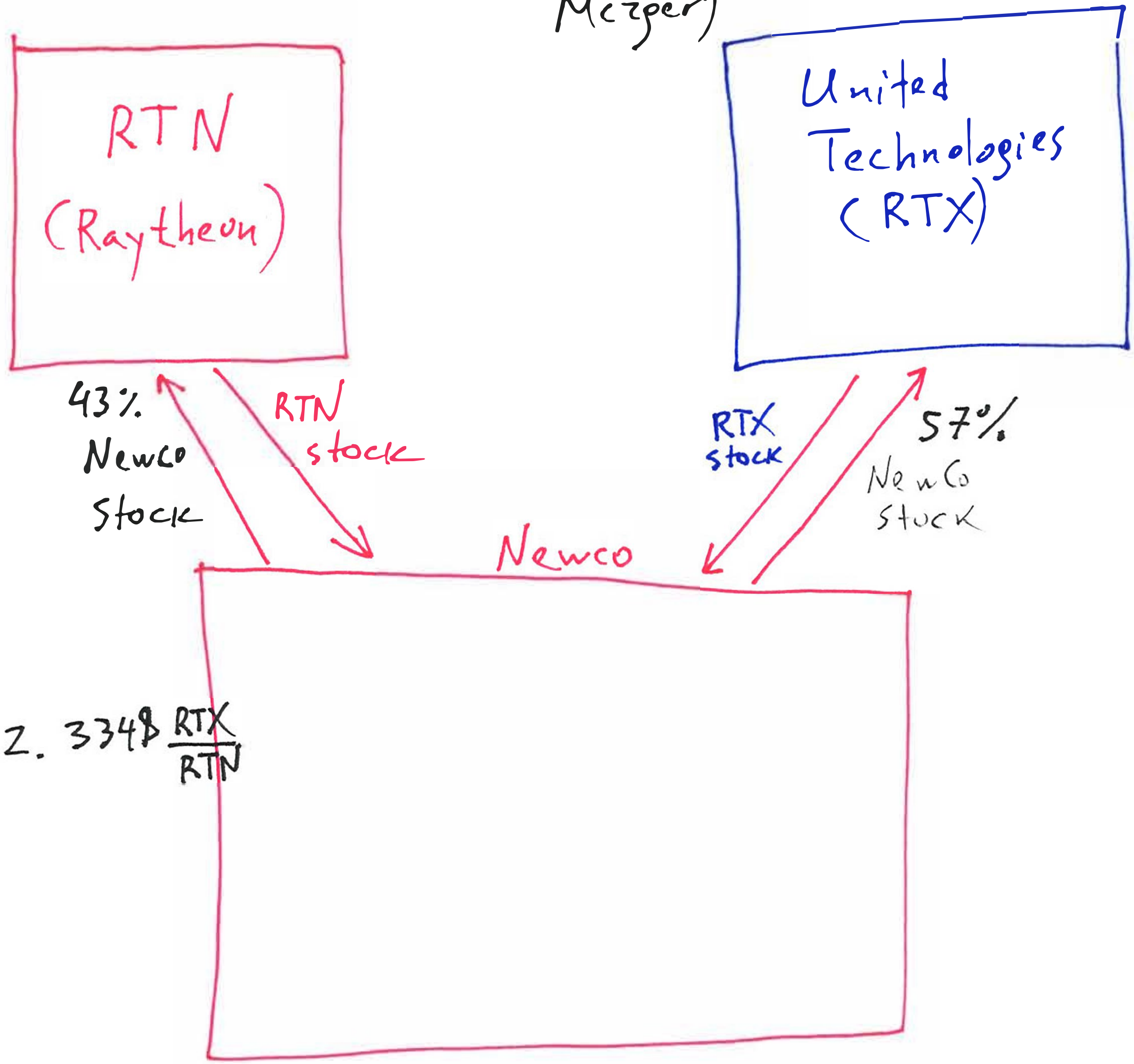
assets basis

✓ Separation of corporate vails

✓ Short form merger in Delaware – no vote on merger if ≥ 90% of stock owned already by buyer!

The example of
RTX - RTN Merger

§ 351 Election
(Stock - for - stock
Merger)



$$\text{Exch. Ratio} = 2.3348 \frac{RTX}{RTN}$$

Example of RTX - RTN merger:

Comparability of firms:

- same risk, r
- same growth, g
- same cash flow characteristics, i.e. payout

Trade comp ratios:

✓ Equity multiples

P/EPS

P/BV

P/FCFE (i.e., free cash flow to equity)

✓ Asset multiples

EV/EBIT

EV/EBITDA

EV = enterprise value
= market cap of equity + assumed liabilities − non-oper. cash

Deal Design I

Asset Purchase vs. Stock Purchase

Deal Design (Part I)

Asset Purchase → double taxation (see Acme Example)

Stock Purchase → importantly a stock purchase needs absolute unanimity among shareholders! (exception: if you do stock redemption for dissenting shareholder through Zeus transaction)

Statutory Merger

an alternative to a stock purchase IF unanimity of ALL shareholders is not feasible.

in this instance, dissenting shareholders might have "appraisal rights"

We next overviewed the Acme Example of taxation from class.

Asset Purchase

Tax eff. within target:

FMV:

PPrice = $ 50m

→ $ 10m building BV = 2m $

$ 2m patent

$ 18 m client list

→ $ 20 m Goodwill

Recapture vs. Capital Gains Depr.

- Accelerated Depr. (Timing)

✓ - Type of assets (e.g. real estate) ?

Example

Double Taxation in Asset Purchase (of Acme)

Acme Company Sales Price: **$100M**

TAX EFFECTS OF ASSET SALE BY C CORP. EXAMPLE		
Sale of Assets	$100,000,000	= sum of those is the purchase price
Liabilities Assumed	*$40,299,000*	
Total Purchase Price	$140,299,000	
Tax Basis of Purchased Assets	$85,487,000	asset basis from balance sheet
Taxable Corp. Income	$54,812,000	
Corp. Tax @ Combined 39%	$21,376,680	
Distribution of Cash to Shareholders	$78,623,320	= 100 − 21.376
Tax Basis of Shareholders (Assumed)	$20,000,000	→ stock basis
Capital Gain of Shareholders	$58,623,320	= 78.6 − 20
Sharholder Capital Gain Tax @ 15%	$8,793,498	→ cap-gains tax
Net to Shareholders	$69,829,822	⇒ net after both taxes

Example courtesy of J. Lehrer, WashU Law

Buyer can write-up tax basis purchased assets: $85.5M → $140.23M

IF write-up of assets to Goodwill → amortized over 15 years

Example of Goodwill Amortization
(based on Acme Example from class)

Assume Fair Market Value (FMV) allocation is 85.487 m in Acme example (an oversimplification) $\Rightarrow$

$$\text{Goodwill} = \$140.299 - \underbrace{85.487}_{= FMV} = \boxed{\$\,54.812\text{ m}}$$

- Amortize over 15 years.
- Assume such amortization shields against 39% tax

$\Rightarrow$ Annual Shield = $54.812 * .39 / 15$ years = \$1.425 million/year

$\Rightarrow$ Value of annuity of tax shields: (with financial calculator)

N = 15

I% = 4% (assumed cost of debt)

PMT = +1.425 m

FV = 0

PV = ? $\Rightarrow$ \$15.844 m

Tax gain even higher if buyer MTR > 39%.

so using asset purchase (instead of stock purchase) buyer makes [illegible]

ASSUMING STOCK PURCHASE (SALES PRICE $100 MILLION) & SHARHOLDERS' TAX BASIS $20 MILLION

Tax Effects of Stock Purchase	
Total Price for Stock	$100,000,000
Shareholders' Tax Basis	stock Tax Basis {$20,000,000
Capital Gain	$80,000,000
Capital Gain Tax @ 15%	$12,000,000
Net to Shareholders	$88,000,000

note in stock purchase price is $100, not $140.3 why?
- Because we assume all assets & liabilities (so no need to repay $40.3 m debt)

net to shareholders

Note: **Buyer cannot step up tax basis of target assets.**

Bottom line: Compared to a Stock Purchase Transaction, an Asset Purchase (of a C Corp.'s Assets) Costs the Shareholders of the Target ($88,000,000-69,830,822) $\boxed{\$18,169,178}$ in Taxes

FAIR?

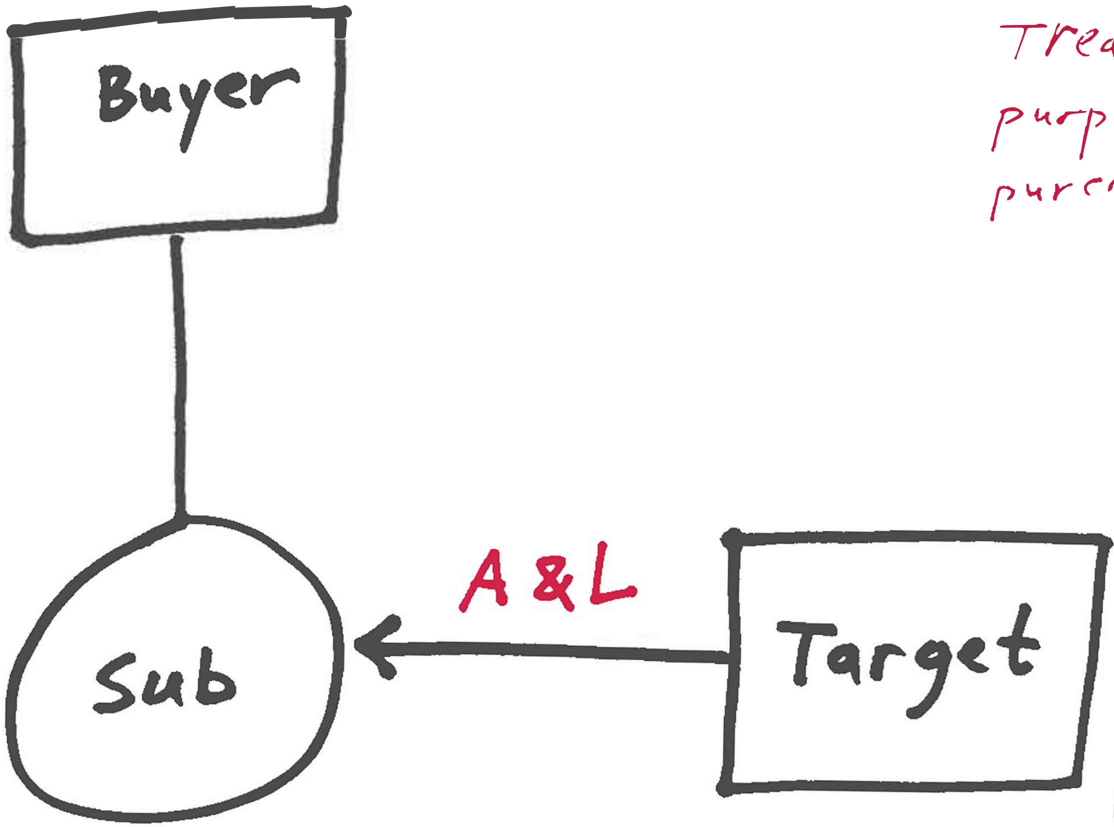
There could be net decrease in tax

Example courtesy of J. Lehrer, WashU Law

compare seller loss

Reverse Triangular Merger

Treated for tax purposes as stock purchase



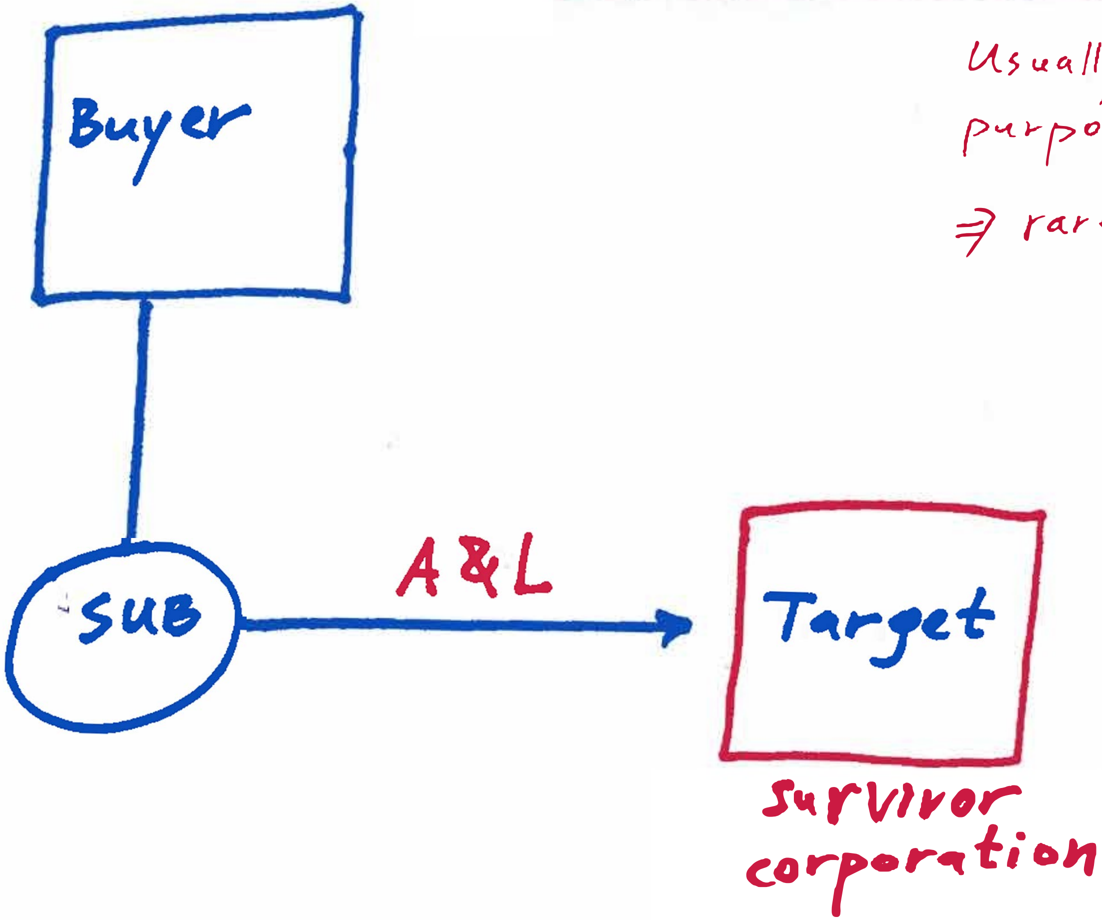
Survivor Corporation

- If executed in the format of §368(A) of I.R.C. code ⇒
  - ✓ tax-free merger
  - ✓ most common merger format

Forward Triangular Merger

Usually treated for tax purposes as asset purchase

⇒ rarely seen



Deal Design - Extended

Methods to Acquire a Public Corp

(1) One-step Merger → fast if you plan to achieve 100% control

(2) Tender offer + back-end merger (also known as "freeze-out" merger)

(3) Three-piece suit

→ "look-up" ("toe-hold") ownership up to a threshold defined by the poison pill

Moran v. Household case (1985)

This case established the validity of a poison pill

"shadow poison pill"

hence we now have

→ .... then a corporation can implement one at a short notice

- "Three piece suit" (continued)

After acquisition of a "toe-hold" ownership in the target,

there are two more steps:

- Tender offer
- Freeze-out merger
  (Short-form if 90% or more acquired in tender offer)

Deal Design (Extended)

Methods of Public Company Acquisition

- One Step Merger

  HSR disclosure

- Tender offer followed by merger

  freezeout

- Three-piece suit
  * Acquire lock-up (or toe-hold) ownership (we discuss here importance of poison pill statutes)
  * Make tender offer @ SAME price
  * Back-end ("Freeze-Out") Merger (possibly of the short-form kind)

    if pre-merger ...ship ≥ 90%

Delaware Merger Statutes

- Appraisal rights DGCL §262
  - Can file for appraisal rights only in stock purchases or stock-for-cash mergers
  - Limitations in case of stock-for-stock merger
  - No appraisal rights for asset purchase
  - Has 120 days to file
- Short form merger
  - If controlling S.H. has > 90% of target stock (& therefore no S.H. vote by target is required)

Discussion of Tender Offers / Exchange Offers

offers with cash payment

offers with stock payment

what is a tender offer?

- Eight-Factor test
- Totality of Circumstances test

Exchange Offer → same, effectuated w/ stock

Subsequent Offering Rule 14D-11

- Initial tender need be for all stock
- Bidder must announce results of initial tender
- subsequent offer for at least 3 days open & @ most 20 days open

Mandatory Disclosure of Target Position – 10 days Rule 14E-2 (a)
(i.e. "Stop, Look & Listen") ...tion

Tender Offer vs. One-Step Merger

- No pre-clearance
- speed
- Direct
- Can be made conditional

- 100% ownership
- Timing advantage
- Can acquire shares in market (not available in tenders)
- No violations of "Best Price" rule

Williams Act (1968)

Schedule 13 D → disclosure of beneficial ownership ≥ 5%

- who is considered owner?
- what to disclose?

Section 14(E): time period for offer & target company disclosure obligations

Section 14(D): disclosure of tender offer if anticipate beneficial ownership > 5%

Best price rule <u>14D-10</u>

- need pay highest price to all shareholders

Rule 14E-5: cannot purchase outside of tender → begins upon public announcement

This note was prepared based on a note to that matter by Goldman Sachs.

A Note on Special Purpose Acquisition Companies (SPACs)

- SPAC is a "blank-check" company formed with the intention of acquiring or merging with another company.

- The SPAC needs to complete an acquisition within two years or the capital raised must be returned to investors, as such it mostly represents a vote of confidence in the sponsor or investor behind the SPAC and in their ability to find future deals that would generate a high ROI.

- In a typical SPAC structure, the sponsor raises initial capital by issuing units consisting of **1 share and ½ or ⅓ of a warrant.**

- The shares are generally priced at $10 and the warrants are typically struck 15% out of the money ($11.50) with a 5-year term and an $18 forced exercise.

- It comes with an embedded put option: Because the acquisition target is unknown at the time of the IPO, potential value creation is completely dependent on the ability of the sponsor to identify a target (typical private) company and negotiate the purchase. The SPAC purchase represents the de facto IPO for the acquired firm. However, in exchange for not knowing ahead of time the specific company that will be acquired, SPAC investors receive two benefits.

    - First, the right to evaluate the pending purchase and elect to hold or redeem the initial investment at cost (plus accrued interest) two days before the vote.

    - Second, warrants. The decisions are separate. A SPAC investor may choose to retain both the shares and warrants, or redeem the shares and hold the warrants, or sell both.

- The SPAC sponsor is typically compensated with **a promote equal to 20% of pro forma equity and warrants.** In a US SPAC, the sponsor's promote is not contingent upon meeting any financial targets. However, the sponsors of some recent SPACs have put their equity promote into an earn-out that is only received if the company achieves certain performance objectives, further aligning the financial incentives of the SPAC sponsor and shareholders.

- European SPACs are structured slightly differently. First, since they lack a redemption feature, they are truly "blank check" firms. The European SPAC investor owns the shares regardless of whether the investor likes the acquisition or not. Second, the sponsor does not receive a 20% promote up front. Instead, the sponsor only earns a promote if the company achieves certain return targets.

- Once the IPO is complete, and the SPAC sponsor - now with millions in fresh funds in the bank - finds a suitable target, he or she negotiates a non-binding term sheet. Depending on the size of the transaction, the sponsor may wall cross potential new outside investors to raise a PIPE (private investment in public equity). The transaction is then announced to the public and an 8-K is filed.

- The SPAC investor base is highly fluid and as Goldman writes, many SPACs experience nearly a full rotation in their shareholder base during the time between the announcement of the deal and closing of the acquisition (transition from merger arbitrage traders and hedge funds to longer-term fundamental investors).

- The sponsor will then file a proxy with the SEC, conduct a pre-merger roadshow, receive redemption notices (if any), and hold a shareholder vote. Redemption notices are due 2 days prior to the shareholder vote, and shareholders will typically determine whether or not to redeem based on where shares are trading at the time redemption notices are due. If the vote passes, the SPAC merges with the target company and will often undergo a ticker change to reflect the name of the target business.

- On the other hand, if the vote fails, the sponsor will resume searching for a suitable target. After 24 months from the capital raise the SPAC will be closed and the capital returned to investors if a merger has not been completed.

- Benefits of SPACs:
  - First, in the traditional IPO process, issuers are prohibited from including any forward-looking guidance in their Form S-1 registration.
    - As a result, prospective investors are required to evaluate the merits of an issue based on backward-looking results and their own expectations.
    - In contrast, the SPAC due diligence process allows a target company to present forecasts and enhances the ability of a SPAC to acquire early-stage companies or those with complicated business models. This can be useful in businesses like sports betting, cannabis, electric vehicles, or other nascent industries that lack meaningful comparisons in the traditional IPO market. Of course, it is a given that the target company will present the most optimistic projections to potential investors, which is why removing the investor diligence aspect of the process is usually a sign of complacent groupthink whereby the investor base is willing to believe anything the target company presents similar to how i) rating agencies assessed all pre-crisis debt as stellar even if it was generally garbage and ii) investors are willing to engage in groupthink when someone else does their "diligence" job for them.
  - Second, in a traditional IPO, the amount of new capital raised is limited, typically to 20%-25% of the value of a company. But in a SPAC transaction, no limit exists on potential proceeds. A SPAC may acquire a majority or minority interest in the target firm and the concurrent PIPE capital raise may be any size.

Purchase price = Assumed Liab. + Market Value of Equity

Make-up Quiz #2 (Week #2) for FIN 5372

✓ *Question #1 (0.5 pts)*

The purchase price in an asset purchase is determined (and taxed) as: the sum of the net price and the assumed liabilities minus the depreciated book value of the purchased asset.

- **A. True**
- B. False

Question #2 (1 pts)

✓ Which of the following could potentially be an issue in an asset purchase?

- ✗ A. Dissenting shareholders may have appraisal rights
- ✗ B. Successor liability may still follow
- ✗ C. Not all assets are assignable to the buyer
- ✗ D. Selling shareholders are taxed at both corporate and personal level
- → **E. All of the above**

✓ *Question #3 (1 pts)*

Who is liable for environmental concerns in a stock purchase?

- ✓ **A. The target remains liable, but the parent company of the target is not**
- B. The target is not liable, but the parent company of the target is
- C. The buyer remains liable, but the parent company of the buyer is not
- D. The buyer is not liable, but the parent company of the buyer is

Question #4 (0.5 pts)

✓ Rule 14E requires that tender offer be held open for at least 20 business days from date it first published.

- **A. True**
- B. False

Question #5 (0.5 pts)

✓ In the state of Delaware, short form mergers require a vote by the target shareholders.

- A. True
- **B. False**

Question #6 (0.5 pts)

Can goodwill be amortized for tax purposes in a stock purchase?

- ✓ A. Yes
- **B. No**