Online Class / Week #8

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(1) Complete discussion of poison pills

(2) Regulation in M&A

(3) Conrail A & B cases

Course Evaluation:

eval.ou.edu

Thank you for taking the time to complete it!

✓ Final Exam

- Wednesday, 12/, 12:01 am CST - Sunday, 12/12, 11:59 pm CST
- 90 + 5 minutes to complete
- Five questions, selected at random from the list of eligible questions

(Continuation from last class)

M&A Defense Mechanisms

Internal Mechanism:
- staggered board
- ✓ - poison pill
- super majority requirement to amend charter or bylaw
- dual class structures

External Mechanisms:
- Regulators
- Activist investors
- Market for corporate control

Discussion of Takeover Defenses & Poison Pills

shadow pill vs. visible poison pill

A visible poison pill = A discriminatory dividend rights plan!

Example:

Flip-Over Pill Example: (more common in Europe)

	Buyer	Seller
Before merger	$\boxed{51\%}$ (sh)	$\boxed{49\%}$ (sh)

$\boxed{\text{After}}$ merger w/ flip-over pill

$$\frac{51+\cancel{0}}{51} \qquad \frac{49+49}{98} \text{ newly issued shares (as dividends)}$$

$$\boxed{\frac{51}{51+98} = 34.2\%}$$

$$\frac{98}{51+98} = \boxed{65.8\%}$$

Discussion of poison pills

Poison pill — a discriminatory dividend plan executed by the corporate board against an acquirer (unsolicited) who acquires X% or more of the target stock.

- everyone else among shareholders gets stock dividend @ discount price
- control-seeking acquirer does not get such dividend
- usually X is 10%

Poison pills types:

✓ – flip-in ⟶ e.g. Conrail had it; it permits sharehol[ders] except acquirer, to purchase additional shares at a discount. It dilutes shares held by hostile acquirer while such acquirer is attempting to gain control.

✓ – flip-over

⟶ Enables shareholders (who do not seek control) to purchase acquirer's shares after merger @ a discount

Poison Pill

Tactic utilized by companies to prevent or discourage hostile takeovers.

Types:

1. **"Flip-in"**

Permits shareholders, except acquirer, to purchase additional shares at discount. It provides investors with instantaneous profits & dilutes shares held by the acquirer.

2. **"Flip-over"**

Enables stockholders to purchase the acquirer's shares after merger @ discount. For example, shareholder has right to buy stock of acquirer in subsequent merger @ two-for-one rate.

Standstill agreements

The target's final concern is that having divulged its trade secrets to the buyer, the buyer will short-circuit the merger negotiations and proceed to acquire the target through open market purchases or a tender offer directly to target shareholders. Some confidentiality agreements will prohibit the acquirer from purchasing, in the market or through private transactions, shares of the seller for a specified period of time—generally two to five years. This agreement of the buyer is sometimes more broadly drafted to preclude initiation or participation in unsolicited tender offers or proxy solicitations.

no proxy solicitation

no tender offers that are unsolicited

The buyer will often request that the standstill should permit the right to purchase a toehold interest in the target, up to 4.99 percent of its shares outstanding—just below the five percent threshold for reporting the equity stake to the SEC as required by law.[2] This is both an expression of serious interest to the target, and a means of hedging against the loss of the target to another buyer willing to pay a higher price. Profits on toehold positions are sometimes justified as compensation for expenses incurred in due diligence and deal development.

Generally, the standstill is most relevant for public targets, whose shares are traded on an exchange. But the standstill could also be highly relevant for a privately owned target where the shareholders have divided into opposing groups with one group threatening to sell to the next available buyer.

The standstill agreement takes the form of a brief letter signed by the buyer and countersigned by the target. It is often signed early in the deal development process and often bundled with agreements about confidentiality, exclusivity, and termination.

Additional Discussions:

Governance Mechanisms

(in the context of alternative methods to transfer control over the corporation)

alternative to M&A

Discussion of incentive compensation

Incentive Pay format

- Options no more
- RSU — restrictive stock units
- PSU — performance stock units

authorized, but not issued

Discussion of classified boards

Classified Board –

Board with multiple classes of directors

e.g. 9 board members → Class I (3) 2020 elec

Class II (3) 2021

Class III (3) 2022

Alternative: proxy fight → buy stock & then attempt to raid the board

(shareholder meeting)

Board of Directors

[Unitary vs. Classified Board]

Unitary → 1 class (elected annually)

Classified Board → 3 classes (one class only elected each year)

use of Bloomberg For M & A data

MRGC → pro-forma valuation (for potential deal scenarios)

BUYP → complete deal detail + timeline

MA → for the entire market

HP/Compaq
Conrail A
Seagate

} mandatory reports for 3 case studies

M& A Regulation

SCENARIO I CALCULATIONS

Scenario 1: #6 and #10 merge

HHI Indexes before the contemplated transaction

		Based on Revenues		
		Revenues	% Market Share	(Market Share)^2
Market Players				
	1	100	18.2	330.6
	2	90	16.4	267.8
	3	80	14.5	211.6
	4	70	12.7	162.0
	5	60	10.9	119.0
	6	50	9.1	82.6
	7	40	7.3	52.9
	8	30	5.5	29.8
	9	20	3.6	13.2
	10	10	1.8	3.3
Total		550	100.0	**1272.7**

HHI Indexes after the contemplated transaction

	Based on Revenues		
	Revenues	% Market Share	(Market Share)^2
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1	100	18.2	330.6
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5	60	10.9	119.0
7	40	7.3	52.9
8	30	5.5	29.8
9	20	3.6	13.2
Newco (=#6+#10)	60	10.9	119.0
Total	550	100.0	**1305.8**

HH < 1,800, review by FTC unlikely

SCENARIO II CALCULATIONS

Scenario 2: #1 and #2 merge

HHI Indexes before the contemplated transaction

	Based on Revenues		
Market Players	Revenues	% Market Share	(Market Share)^2
1	100	18.2	330.6
2	90	16.4	267.8
3	80	14.5	211.6
4	70	12.7	162.0
5	60	10.9	119.0
6	50	9.1	82.6
7	40	7.3	52.9
8	30	5.5	29.8
9	20	3.6	13.2
10	10	1.8	3.3
Total	550	100.0	1272.7

HHI Indexes after the contemplated transaction

	Based on Revenues		
Market Players	Revenues	% Market Share	(Market Share)^2
Newco (=#1+#2)	190	34.5	1193.4
3	80	14.5	211.6
4	70	12.7	162.0
5	60	10.9	119.0
6	50	9.1	82.6
7	40	7.3	52.9
8	30	5.5	29.8
9	20	3.6	13.2
10	10	1.8	3.3
Total	550	100.0	1867.8

HHI > 1,800, review by FTC very likely

M&A Regulation & Defenses

Anti-trust regulation follows a process to determine the effect of the merger on competition:

$$HHI = \sum_{i=1}^{N}\left[\frac{S_i}{\sum_{i=1}^{N} S_i} \times 100\right]^2$$

Herfindahl-Hirschman Index (HHI)

HHI is used to determine the level of market concentratio[n]

If HHI > 1,800 ⇒ FTC and DOJ will interfere

$$\text{Cross-elasticity} = \frac{\%\,\Delta Q_B}{\%\,\Delta P_A}$$

An important aspect of the review is the definition of the market. If

cross-elasticity > 1 ⇒ convergent (i.e. similar) market

Conrail A Case Discusssions

Conrail A:

Not an equilibrium! Why?

If for example X deviates from it & does not tender, then Y's payoff of tendering is 92.50, but if Y does not tender, payoff is 96.8
⇒ Y has also incentives to deviate!
⇒ not an equilibrium

		Y: Tender	Y: Do not
X	Tender	$X = \boxed{89.07}$ $Y = \boxed{89.07}$	$X = 92.50$ $Y = 86.78$
	Do not	$X = 86.78$ $Y = 92.50$	$X = \boxed{96.84}$ $Y = \boxed{96.84}$

Bottomline: If anticipated payoff of non-tender is sufficiently low, it will make shareholders tender

"Do not tender" is a unique equilibrium

Conrail A:

Enterprise Value = Total Firm Value
- Cash
(Non-operating)

we can think of enterprise value as
the net acquisition cost of the firm

MRGC → Function in Bloomberg to retrieve the merger calculator

Two-way table in Excel – robustness

Important to value cost savings & revenue enhancements w/ different discount rates

$$WACC_{CSX-CONRAIL} = 14.18\%$$

Why 40% in
tender offer?

$40\% * 90.5 = 36.2$ m
Lockup option $= 15.96$ m

CSX $= 52.16$ m

Total $= (90.5 + 15.96) = 106.46$

$\approx 49\%$

+ 1.01% from management

Discussion of Conrail Case

State-Antitakeover Provisions & Merger Contract Anti-takeover Provisions

✓ **Two-tiered offer**

First stage {
- acquisition of up to 10% (due to poison pill)
- acquisition of up to 20% (due to fair price law in PA)

second stage { freeze-out merger (stock-for-stock)

✓ **Lock-up Option**

✓ **Break-up Fee**

✓ **Poison Pill**

Discussion of Conrail B

Valuation of Conrail in the auction:

- include synergies
- include opportunity cost of failing to acquire conrail
- (for Norfolk Southern) include also value of break-up fee & value of "lock-up" warrants to CSX

To Opt-Out or Not?

Conrail Shareholder Decision Payoff Matrix Jan. 16, 1997

Conrail Shareholder Opt-Out Vote

OPT-OUT

Shareholder Y	Shareholder X: Tender	Shareholder X: Don't Tender
Tender	X = $102.2 Y = $102.2	X = $99.53 Y = $110
Don't Tender	X = $110 Y = $99.53	$\boxed{\text{X = 99.53 through 115; Y = 99.53 through 115}}$

DON'T OPT OUT

Expected Prices?

Outcome:
the opt-out
vote failed.
why?

if payout of not tendering is sufficiently high, it will unravel the equilibrium of tendering

Payoffs:

Front-end	$110.00		(cash)
Back-end	$99.53	=1.856*45	(ex. ratio * CSX price)
		+$16	(preferred stock)
Blended Value	$102.16	=25%*110	(front-end cash offer)
		+74.7%*99.5	(back-end stock swap)

Note: Front-end / back-end offers 25.3%/74.7% (not 40%/60%) after first stage of front-end completed.

Make-up Quiz #8 (Week #7) for FIN 5372

Question #1 (1 pts)
(Essay Question #1 relates to the HBS case to be discussed in class, ConRail Acquisition-Part A; please target response of about 100 words)
Why does CSX want to buy Conrail? How much should CSX be willing to pay for it?
cost savings, reduction of assets, enhancement of revenue, regulatory shock adjustment $92-$100

Question #2 (1 pts)
(Essay Question #1 relates to the HBS case to be discussed in class. ConRail Acquisition-Part A; please target response of about 100 words)
Why did CSX make a two-tiered offer, i.e., from the bidder's point of view, what are the advantages of a two-tiered offer? What effect does this structure have on the transaction?
coercive offer (back-end of offer is worse than front-end)

Question #3 (1 pts)
(Essay Question #1 relates to the HBS case to be discussed in class, ConRail Acquisition-Part B; please target response of about 100 words)
Why did Norfolk Southern make a hostile bid for Conrail? In a bidding war for Conrail, who should be willing to pay more, Norfolk Southern or CSX?
- significant complementarity (revenue enhancement)
- defensive motivation

Question #4 (0.5 pts)
Essay Question #1 relates to the HBS case to be discussed in class, ConRail Acquisition-Part B; please target response of about 100 words)
As a Conrail shareholder, would you tender your shares to CSX at $92.50 in the first-stage offer? Would you vote to opt-out of the Pennsylvania antitakeover statute?
No & No

Question #5 (0.5 pts)
Business combination state statutes provisions preclude the sale of assets for a specific period following the buyout, thereby inhibiting financing of purchase price.

A. True
B. False

Question #6 (0.5 pts)
The Hart-Scott-Rodino Act provides for mandatory filing with the Federal Trade Commission if a merger or an acquisition of a certain size is agreed upon; it further anticipates 30 day waiting period before transaction can be completed.

A. True
B. False

Question #7 (0.5 pts)
Elasticity tests ("5% rule") is an alternative measure used to determine if merged firm has the power to control prices.

A. True
B. False