

CHAPTER 17

CONCEPT REVIEW QUESTIONS

1. Which industries do you anticipate will experience industry shocks that will spur merger activity in the near future?

The technology industry has been the hardest hit when the stock market began to fall after its peak in March 2000. Often when there is a downturn in an industry, the poorly performing companies are acquired by stronger companies.

2. How does the dynamic interpretation of antitrust laws affect managers' acquisition strategies? What impact does the involvement of individual states have on the acquisition decision?

The dynamic interpretation of antitrust laws affects managers' acquisition strategies. Sometimes antitrust laws are vigorously enforced, while at other times there is very little enforcement. In addition to potentially facing federal prosecution, states are also filing antitrust suits, as in the case of Microsoft where attorneys general from 14 states joined in the antitrust suit.

3. Do you believe that increasing global competition will further heighten merger activity?

Increasing global competition is very likely to spur merger activity. Firms will want to gain footholds in other countries, often through merger with a local company.

4. Why are acquired resources integrated into a company in so many different forms? What transaction-specific circumstances might lead to a preference of one integrative form over another?

There are a number of ways to integrate acquired resources, including statutory merger, subsidiary merger, consolidation, LBOs, MBOs and dual-class recapitalizations, and tender offers, acquisitions and proxy fights. Some of the choice of form depends on whether the acquisition is voluntary. In a hostile takeover, the target firm might not wish to be acquired and a tender offer or proxy fight might result. If high debt is feasible, then an LBO or MBO might be the integrating choice.

5. How does a tender offer differ from a proxy fight? Why might these two corporate control actions be considered different ways to achieve the same objective?

A tender offer involves one company (the bidder) making a public offer to purchase all of the shares of the target company that the target's shareholders are willing to "tender." This is a method of attempting to acquire voting control of another company in a public bid. A proxy fight occurs when one group of shareholders challenges the incumbent board of directors by seeking to acquire the proxies (assigned rights to vote shares) of other shareholders. This is also an (internal) attempt to acquire control—or at least influence—of the company's board of directors.

6. What is the purpose of classifying mergers by degree of business concentration? Why do you think these classifications have changed over time?

Mergers are classified by degree of business concentration to see if a merger will result in too few competitors in a particular industry. The classifications have changed over time because competition has changed over time – first from regional only competition, then national competition and now global competition.

7. As conglomerate mergers and corporate diversification have proven to be failures in general, why would any manager pursue these objectives? Can you think of any cases where corporate diversification has worked successfully? What distinguishes these cases from the norm?

A manager might pursue conglomerate mergers or mergers for corporate diversification because of agency conflicts. A manager is concerned about total risk – his or her personal wealth and job security. The more diversified the company, the better able it will be to weather market fluctuations. This may not be the best choice for shareholders. They can diversify on their own, and they don't need the firm to diversify for them. The manager has more of his/her total wealth tied up in the company and is less able to diversify on his own. Corporate diversification works when there is true value added – when the parts added create synergies, perhaps because of shared overhead expenses. There must be a real cash flow benefit for a merger to be successful.

8. What are the two most important methods of paying for corporate acquisitions?

The two most important methods of paying for corporate acquisitions are with cash and using the company's own stock as a currency. Cash acquisitions are often funded by the bidding firm borrowing the cash needed, although small acquisitions may simply use cash the company has on hand.

9. What is "goodwill" in the context of merger accounting? What must an acquiring company do if the value of an acquired company is revealed to have declined after a merger?

Prior to June 30, 2001, two financial accounting procedures existed for recording a merger in the United States: the pooling-of-interests and purchase methods. However, with implementation of Financial Accounting Standards Board (FASB)

Statement 141 and the near-concurrent (December 31, 2001) Statement 142, there now exists one standard method of accounting for mergers. Under these new standards, target liabilities remain unchanged, but target assets are “written up” to reflect current market values, and the equity of the target is revised upward to incorporate the purchase price paid. These revised values are then carried over to the surviving firm’s financial statements. The intangible asset *goodwill* is created if the restated values of the target lead to a situation in which its assets are less than liabilities and equity. This goodwill reflects the premium that an acquiring firm is willing to pay in excess of net asset market value in order to capture synergies from the merger—goodwill becomes an intangible asset on the balance sheet. Going forward, the value of this intangible asset must be evaluated to determine if it has been “impaired” due to a decline in fair value relative to carrying value. If the value of goodwill is impaired, then the amount of the impairment is “written down” from the goodwill account on the balance sheet and charged off against earnings. Otherwise, it remains unchanged on the balance sheet indefinitely.

10. Who wins and who loses in corporate takeovers? Why do acquiring firm shareholders generally lose in stock-swap mergers but either benefit or at least break even in acquisitions paid for with cash?

Target shareholders almost always win but acquirers’ returns are mixed. The combined value of merging firms also increases, especially in nonconglomerate combinations. The highest announcement-period returns are found in mergers between well-managed acquirers and poorly managed targets. Long-term performance is highest for focus-increasing deals financed with cash and lowest for diversifying mergers financed with stock.

11. What characteristics surrounding a merger would lead you to conclude that it is motivated by value-maximizing managers rather than non-value-maximizing managers? What actions could directors or stockholders take to prevent non-value-maximizing mergers?

If investors believe a merger will increase value, the stock prices of the companies will increase prior to the merger. The merger will be judged on changes that will occur after the merger – expectations of higher revenues, lower costs, lower taxes or lower investment needs. In non-value-maximizing mergers, the acquiring company shares will drop in value, as investors either believe the firm is overpaying for the target firm or that synergies will not occur after the merger.

12. If you wanted to expand your operations into a foreign country with nebulous laws and an unstable political climate, would you favor internal or external expansion? Why?

To expand operations into a foreign country with nebulous laws and an unstable political climate, you would most likely favor external expansion. Internal expansion into a new market involves acquiring and organizing all resources required for each stage of the investment. External expansion is the acquisition of a firm with resources already in place. This avoids construction delays in building a new facility. Usually, external expansion is the better option in situations where rapid expansion is desired or when great uncertainty exists about the success of any stage of internal expansion. International expansion is also a reason to choose external over internal expansion. Differences in business operations, political climate and culture may mean that an acquisition is the only viable alternative for international expansion.

13. What is the free cash flow theory of mergers? Why do you think that managers might be tempted to pursue size-increasing mergers even when these do not maximize value?

Michael Jensen's free cash flow theory of mergers hypothesizes that managers will use free cash flow to invest in mergers that have negative net present values in order to build corporate empires from which the managers will derive personal benefits, including greater compensation.