

# research newsletter

## Corporate Takeovers

### Introduction

#### Welcome to the first edition of the ECGI Research Newsletter.

We intend to publish three editions a year, focussing on a topical corporate governance issue and drawing on published papers in our Finance and Law Working Paper series. Each edition will comprise a digest of the major themes from these papers, comments from a leading academic and practitioner and a synopsis of a relevant book by one of our Research members.

A copy of each edition of the Newsletter will be posted to members. It will also be available online in the members' area of our website. We trust that you will find it informative and useful. Please do not hesitate to circulate it amongst your colleagues and in this way draw their attention not only to a substantial body of research but also to the ECGI itself.

For this first edition, we have chosen the topic of Corporate Takeovers. This is not only topical, with the Takeover Directive starting to be implemented in EU members states; there are also a number of controversial elements in the Directive which were not adopted and which are coming under review this year. This Newsletter should inform and enlighten the ongoing debate.



[www.fee.be](http://www.fee.be)

The ECGI is extremely grateful to the Fédération des Experts Comptables Européens (FEE), the representative organisation for the accountancy profession in Europe, for kindly agreeing to sponsor this new initiative over the next three years in recognition of the valuable work they believe the ECGI is undertaking.

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### Research digest

Five working papers on this topic have been published by the European Corporate Governance Institute. The papers set out the authors' propositions in detail and supply the accompanying evidence. This article pulls out some of the key strands from the papers which can be downloaded from the SSRN website via the ECGI website [www.ecgi.org](http://www.ecgi.org). Full details of the papers can be found on page 4.

#### Takeover Waves: Triggers, Performance and Motives

There have been five obvious waves of takeover activity, the 1900s, 1920s, 1960s, 1980s and the 1990s. Each wave is characterised by a different set of underlying motives but there are some common factors throughout. Takeovers usually occur in periods of economic recovery (for example, after a market crash, economic depression caused by war, an energy crisis etc). The takeover market is also often fuelled by regulatory changes, such as anti-trust legislation or deregulation and it is frequently driven by industrial shocks in the form of technological and financial innovations, supply shocks (eg oil price shocks), deregulation and increased foreign competition.

At their announcement, takeovers trigger substantial increases in value but most of these gains are captured by the targets' shareholders at the negotiating table. In theory, a successful takeover will lead to economies of scale and increased market value of the combined companies, thus in turn leading to an improvement in operating performance and improved profitability and returns. However, the accounting studies presented in the Paper do not support this argument. It is more usual to see

a decline in the share prices of the acquiring firm over the first five years after the takeover, suggesting that anticipated gains from takeovers are on average non-existent or overstated.

Takeovers which take place at the beginning of a wave usually generate substantial, albeit short-term, wealth for the target shareholders. It is this success which encourages other companies to carry out similar transactions, often motivated by the non-rational decision making of self-interested managers and, since the main motive for these later acquisitions is to mimic the leaders rather than to take a course of action based on a clear economic rationale, these takeovers are less successful and help the wave to come to an end.

### The Toehold Puzzle

Since corporate takeovers require large offer premiums, the case for acquiring shares in the target company (a toehold) prior to making the offer is both intuitive and compelling. Even small toeholds can yield substantial cost savings for the bidder. For example, if Pfizer had purchased a toehold of only one per cent just one month prior to announcing its ninety billion dollar offer for Warner-Lambert in January 2001, Pfizer would have saved about \$250 million in transaction value.

Even if the bidder should lose the contest to a rival, it still gains as the rival acquires the toehold at a premium. The only possible downside to having a toehold is if all the bidders fail and the market reduces the share price to below that paid for the toehold.

The puzzle is that despite the toehold benefits, toehold bidding is rare. The authors found that only 11% of initial bidders in more than twelve thousand contests have toeholds, and that the acquisition of short-term toeholds (within six months of the initial bid) is almost non-existent at only 2%. When looking instead at the acquisitions of partial interests (with no link to takeovers), a similar conclusion emerges. In a sample exceeding ten thousand partial acquisitions, less than 5% led to a follow-on control bid.

The authors address this puzzle by suggesting three sources of toehold costs and testing whether these are likely to outweigh the benefits.

- 1 Approaching the target with a toehold might reduce the target's willingness to negotiate a friendly deal. The reason is that if the bidder abandons negotiations and instead launches a hostile tender offer, the toehold increases the probability of the bidder winning the hostile auction. Therefore, approaching the target with a toehold can be seen by the target as being aggressive - akin to saying "let's negotiate or else". The target may

react to this aggressiveness by imposing resistance costs on the bidder. The authors consider one such cost: refusing to grant the bidder a termination agreement. They use bidding theory to compute the cost to the acquirer of the forgone value of the termination agreement. They then estimate this cost and find that it helps explain the cross-sectional variation in the use of toeholds. The authors conclude that potential resistance costs, as exemplified by the opportunity cost of termination agreements, are the factor most likely to explain the toehold puzzle.

- 2 If the target resists all bidders, toeholds or not, it is possible that no bidders win and that the value of the toehold shares fall below what was paid for them. Surprisingly as many as one third of all contests initiated by a friendly merger bid result in no-bidder-wins outcomes. However, the authors find that toehold bidding in fact helps reduce the probability of no-bidder-wins outcomes, and that they estimate the expected value of the toehold to be positive. So, the authors conclude that the no-bidder-win outcome is unlikely to explain the toehold puzzle.
- 3 If the toehold acquisition results in pre-takeover run-up in the target share price, this in turn could increase the premium that the bidder has to offer. The authors report substantial evidence of mark-up pricing across mergers and tender offers. However they also show that the total abnormal return to the bidder increases both in the target run-up and in the toehold so they doubt that mark-up pricing is a viable explanation either.

### Tender Offers and Leverage

The third Working paper looks at the role of leverage and the role of financing choice in tender offers for widely held firms. One of the characteristic features of the 1980s takeover wave was that tender offers were frequently highly leveraged. As the raider often had no, or only a few, assets of his own, the assets of the target firm would serve as security for his debt. Effectively, the raider does not just bring in a value improvement alone, but a value improvement that has a pre-existing liability attached to it. This is known as a bootstrap acquisition.

In a bootstrap acquisition the debt is issued by a special acquisition vehicle which, after the raider has gained control, is merged with the target firm to provide the holders of the debt with a legal recourse to the pledged assets. This means that the tender offer is followed by a subsequent merger and the debt assumed by the raider enters into the combined firm's capital structure, lowering the firm's equity value.

The paper considers models for possible sources of financing: the raider providing all the cash out of his own pocket; or he issues equity; or he issues debt; or a mixture

of these methods, and shows that the optimal financing mix is to issue debt and then if (but only if) the funds from the debt are insufficient to cover his financing needs, the raider finances the residual with equity or cash out of his own pocket if possible.

The authors go on to explore the role of bankruptcy as a natural counterforce to high leverage and the interplay between leverage and toeholds. They look at how the target firm can ward off hostile takeovers by manipulating its net worth (for example by selling assets or undertaking a leveraged recapitalisation) and the effect of raising debt on the raider's own incentives. If the increase in value is dependent upon the raider's efforts, he will get reduced benefits if part of them are needed for the debtholder.

The Paper finishes by looking at the legal position of the merger following the tender offer, both the legality of the merger itself and of its terms.

#### **Minority Blocks and Takeover Premia**

A 2005 report showed that 59% of listed US firms have a blockholder owning (directly or indirectly) at least 10 per cent of the firm's shares. Faced with a takeover attempt, target blockholders often choose not to launch a counter-bid because they lack the financial resources or the managerial capabilities to run the firm. If the target blockholder is an institutional investor, such as a pension fund, it is prevented from launching tender offers anyway.

In many existing takeover models, the presence of such a 'passive' minority blockholder does not alter the outcome. This Paper puts forward a model where it does, because the blockholder's tendering decision interacts with the tendering decisions of the small shareholders. This is because of a post-takeover incentive problem on the part of the successful bidder.

The successful bidder can decide to divert part of the revenues generated under his control as private benefits, but this is inefficient and exhibits decreasing returns in scale. The more shares the bidder owns, the more this inefficiency impinges upon himself and therefore the less likely he is to extract private benefits. This in turn implies a higher post-takeover share value.

It is this link between the number of shares owned by the bidder and the post-takeover valuation of the shares which has an impact on the decisions of the small shareholders in relation to the position taken by the blockholder. The more shares the blockholder tenders, the fewer will be tendered by the smaller shareholders in order to make the post-takeover share value match the bid price.

This relationship implies that the small shareholders' supply in the tender offer increases with the bid price but decreases with the number of shares tendered by the blockholder. It also means that the blockholder tenders his entire block in an equilibrium in which the bid succeeds.

As a result, the blockholder is potentially decisive for the outcome of a tender offer and this is important if he values the status quo highly. In this case, the bidder must offer a higher price to either win the blockholder's support or to attract enough shares from the small investors so that this support is not needed. This benefits the small shareholders, provided the takeover is actually launched. The authors also contend that the presence of a 'passive' minority blockholder presents a partial safeguard against value-decreasing bids.

#### **Corporate Governance Convergence: Evidence from Takeover Regulation**

The final Paper in this section looks at the impact of the recent reforms of takeover regulation in Europe and discusses whether or not a process of convergence towards the Anglo-(American) corporate governance system has begun, and looks at whether such a convergence is desirable.

There are two polar systems of corporate governance: the market-based system and the blockholder-based system. The former prevails in the UK, US and the Commonwealth countries, and relies on legal rules largely resulting from case law and on the effective legal enforcement of shareholder rights. The blockholder-based system of Continental Europe relies on codified law and emphasises rules protecting stakeholders such as creditors and employees. The two systems differ not only in terms of the rationale behind their legal rules, but also in terms of their ownership and control. Most Continental European companies are characterised by majority or near-majority stakes held by one or a few investors. In contrast, the Anglo-(American) system is characterised by dispersed equity.

Takeover regulation is an important element of corporate governance. Changes in takeover regulation affect the level of investor protection, the development of capital markets and the market for corporate control as well as potentially causing changes in ownership and control. The paper identifies and describes the main provisions in takeover regulation in 30 European countries and analyses how this regulation has changed over the past 15 years.

To date, no consensus has been achieved about which is the most effective corporate governance system, the European model, the Anglo-(American) model or a hybrid of the best from both systems. This Paper shows that, despite all the controversies, the EU countries have individually undertaken steps toward the convergence of takeover and corporate governance regulation. However, there are still major differences across Europe, so this does not imply that the corporate governance regimes are truly converging towards a single system.

## Working Papers

**Takeover Waves: Triggers, Performance and Motives** by Marina Martynova, Department of Finance, Tilburg University and Luc Renneboog, Department of Finance, Tilburg University and ECGI (Finance #97/2005)

**Minority Blocks and Takeover Premia** by Mike Burkart, Department of Finance, Stockholm School of Economics, CEPR, ECGI and Financial Markets Group, University of London, Denis Gromb, London Business School, CEPR and ECGI, and Fausto Panunzi, University of Bocconi - Institut (Finance #96/2005)

**The Toehold Puzzle** by Sandra Betton, Concordia University, B. Espen Eckbo, Tuck School of Business at Dartmouth and ECGI, Karin Thorburn, Tuck School of Business at Dartmouth, CEPR and ECGI (Finance #85/2005)

**Tender Offers and Leverage** by Holger M. Müller, New York University and CEPR and Fausto Panunzi, University of Bologna, CEPR and ECGI (Finance #22/2003)

**Corporate Governance Convergence: Evidence from Takeover Regulation** by Marc Goergen, University of Sheffield and ECGI, Marina Martynova, Tilburg University and Luc Renneboog, Tilburg University and ECGI (Law #33/2005)

Two other papers have been published in this area which were not available for review at the time of writing this article. They are:

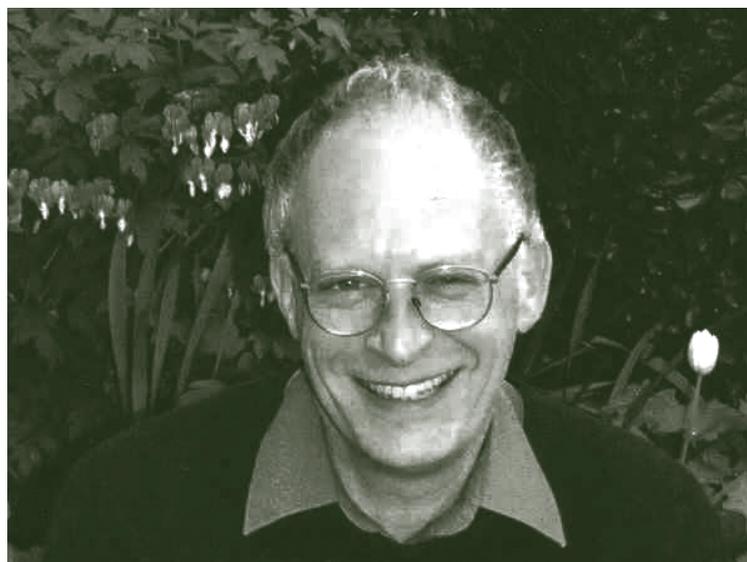
**Takeovers** by Mike Burkart, Department of Finance, Stockholm School of Economics, CEPR, ECGI and Financial Markets Group, University of London and Fausto Panunzi, Institute of Economics "E. Bocconi" (IEP), University of Bocconi, IGIER, CEPR and ECGI (Finance #118/2006).

**Mergers and Acquisitions in Europe** Marina Martynova, Tilburg University and Luc Renneboog, Tilburg University and ECGI (Finance # 114/2006 )

## An academic viewpoint

Professor Oliver Hart is Andrew E. Furer Professor of Economics, Department of Economics, Harvard University, USA and is currently Vice President of the American Economic Association. He has been an ECGI Fellow since 2002 and has had a keen interest in corporate finance, take-overs and the theory of the firm for more than 30 years. We asked him to bring his own perspective to what's been going on in the world of take-overs as a way of pulling together the ideas and theories set forward in the papers summarised later.

In 1980 he, together with Sandy Grossman, wrote a paper



Professor Oliver Hart

"Take-Over Bids, the Free Rider Problem, and the Theory of the Corporation" which was published in the *Bell Journal of Economics and Management Science II* (Spring 1980) 42-64. This paper expounded their view that small shareholders in a public company face severe collective action problems, which act as a disincentive to monitoring of executive performance. If a small shareholder performs such monitoring and if this resulted in an improvement in performance, not only would the return they, as a small shareholder, personally gain be only a tiny proportion of the total, but they would also bear all the costs themselves of an action which would actually benefit all the shareholders.

In the paper Hart and Grossman looked at possible ways of avoiding this problem and argued that one solution could be found in the presence of corporate raiders who have an excellent incentive to monitor management closely and find ways to improve the company, then launching a hostile take-over bid on the promise of greater returns once the changes they have identified are implemented. If everything works according to plan for the raider, the small shareholders benefit from getting a small premium and the raider takes a large profit. For example, if the shares are worth €100 each and the raider feels that if he had control of the company he could make changes which will increase the stock value to €150, he will offer €101 per share and pocket the additional €49 per share himself. Henry Manne first described this mechanism.

However, Hart and Grossman identified a problem with this which they called the Free Rider Problem. Why would any shareholder agree to sell stock at €101 which they thought would shortly be worth €150? If they held on to the stock they would see a much greater return and, being

a small shareholder, their action should not be sufficient to stop the bid happening. The real problem lies in the fact that if everyone thinks that way, the bid of €101 will fail and the mechanism identified by Manne will not work.

In addition, there are costs associated with launching a take-over in raising funds and running the tender offer which are borne by the raider. If he then has to buy the stock at a price which represents the full post-improvement value of the company, not only does the raider not personally benefit from the additional value for the new stock he acquires, but he could actually lose money when taking into account the costs incurred in the process. This then makes the take-over an unattractive prospect, discouraging the raider from monitoring management and identifying areas for improvement and then nobody benefits.

Hart and Grossman proposed a possible solution to this problem, which was to allow the raider to expropriate minority shareholders by, for example, diverting resources from the company to himself, very much as described in the Müller and Panunzi paper (Tender Offers and Leverage) summarised within this newsletter. If the raider can "steal" the additional €50 of value per share in some way, then individual shareholders are more likely to be prepared to sell at the €101, or even the €100 value. Although this activity is at least questionable, it does have the benefit of ensuring that raiders do continue to do a good job identifying under-performing companies and making them perform better in the longer term. However, this would of course cause shareholder dilution and would have to be agreed with shareholders in advance and sanctioned by them.

Professor Hart now says he thinks that he and Grossman may have focussed too much on this particular free rider problem. In practice the kind of dilution they were arguing for already existed in some jurisdictions. For example, in the US a successful bidder can engage in a freeze-out merger and in the UK, once an acquirer gets control of 90% of shares, they are entitled to buy out the remaining 10% at a fair value.

In practice, other free rider problems may be more important. The raider is seldom operating in a vacuum. He is competing with incumbent management and other bidders. If the incumbent management takes on board and institutes the improvements themselves, the value of the company will increase but the raider will not enjoy most of the increase himself. If other bidders come in when the company is under offer to try to take advantage of the situation, this can push up the share price but once again the raider does not make a high personal return. In all these cases, the shareholders as a whole could benefit from the activities of the raider but the incentive is not so great for the raider.

Professor Hart points out that his paper was written before the 1980's take-over wave, when raiders were very active but also acquired a bad name. He maintains that raiders

get a bad press generally but that they can be good news as far as shareholders are concerned. The bad way that they were perceived, though, led management in the US to lobby successfully for powerful defensive weapons to fight off potential raiders, for example poison pills which make it more expensive to make a take-over as well as staggered boards which also put obstacles in the way of a take-over. Hostile take-over bids have therefore become much less common, but as Martynova and Renneboog make clear in their paper, *Take-over Waves, Triggers, Performances and Motives*, there have always been waves of take-over activity, and each wave has a different character and different driving forces.

It's not obvious to Professor Hart that the decline of raiders is a good thing. Small shareholders still need some protection and they cannot rely on management and boards of directors, even though these have certainly become more alert to problems recently. It is important to have external monitors as well.

On a more positive note, now that hostile take-over bids are almost prohibitively expensive in the US, what have emerged in their absence are active investors who use their position to exert influence on management. Examples are Kirk Kerkorian who is currently trying to put pressure on the management at GM to make various changes and Carl Icahn who is trying to do the same thing at Time Warner. By buying 3 - 10%, say, of stock in a company, such investors acquire a toehold which means they have an interest in getting an improvement in performance, without making a take-over bid. Effectively such investors become minority blocks as described in *Minority Blocks and Take-over Premia* by Burkart, Gromb and Panunzi.

Professor Hart thinks this is generally healthy but points out that 3 - 10% is still a relatively small shareholding so the incentive of a blockholder to be active is still less than 100%. In addition, the Free Rider problem Hart and Grossman identified in 1980 re-emerges in this context, as was noted by Shleifer and Vishny in 1986. If other shareholders notice that such investors are trying to acquire a toehold then they could hold out for the post-improvement value and reduce the incentive to acquire the toehold for the same reasons as the raider was deterred from launching a take-over bid. Betton, Eckbo and Thorburn discuss the Toehold Puzzle in their paper.

The final paper discussed in this edition of the ECGI newsletter is that by Goergen, Martynova and Renneboog which looks at the convergence of the European model and the Anglo- (American) model of corporate governance. Professor Hart is very clear that too much convergence with the US system would not be a good thing. The ability of management to resist shareholders is a questionable development in the US. Professor Hart hopes that Europe will opt for a system where management is not given too many defensive powers.

## A practitioner viewpoint

Tony Burgess is European Head of M & A at Deutsche Bank and has provided a practitioner's view of what the trends were in mergers and acquisitions in Europe for 2005 and what the outlook is for 2006.

There has been a strong upswing in M & A volumes in 2005 over 2004, and this has been particularly strong in Europe with an increase in deal volume during that period of 37.1%, as compared with 35.8% in the Americas and 33.4% in the Asia Pacific region.

Tony points out that the key drivers of this increased activity have been the return of corporates to M & A, the continued rise of private equity and a burgeoning of deals in the emerging markets of Central and Eastern Europe.

The return of corporates to M&A activity has primarily been driven by the economics of industry consolidation, especially on a pan-European basis. The strategic rationale for most of the industry consolidation transactions has existed for many years. These deals are beginning to occur now for three key reasons.

First, management are ready to make M&A a priority. Following the collapse of the technology, media and telecoms bubble of 1999/2000, companies spent the 2001 - 2004 period repairing balance sheets and rationalising costs and operations. By 2005, operations were largely back under control, balance sheets were in much better shape and the corporates were in a position to launch into a new round of activity.

Second, equity investors have had a one hundred and eighty degree shift in emphasis. During 2001 - 2004 the focus was on higher dividend payouts and share buybacks and investors were opposed to corporates making large acquisitions. However, with the recovery of equity markets in 2005, the focus has shifted to growth and there is now a positive encouragement for companies to make acquisitions. This has been aided by the third factor - financing is readily available for these deals, insofar as strong share prices are providing currency for acquisitions and debt finance remains cheap and abundant.

The re-emergence of corporate M&A activity has been supplemented by the continued rise in private equity M&A activity. In 2005, private equity M&A volumes were up by some 60 percent, and accounted for over 20 percent of the M&A market in Europe. This surge in private equity activity has been driven by the dramatic shift in asset allocation to private equity, underpinning huge new fund raisings, together with the ready availability of cheap debt finance at high multiples.

The third major factor behind the upsurge in M&A activity is the maturation of the emerging European economies, in particular Russia, Turkey, Eastern Europe and the Middle



Tony Burgess

East, which have driven a large increase in the number of deals in those regions. The volume of deals with Central Europe, Middle East or African involvement jumped from \$US25bn in 2001 to \$155bn last year.

Tony says that the expectation is that the cyclical upswing is likely to continue into 2006 and that volumes of deals are likely to be up by at least 20%. He also thinks that the number of mega-deals (defined as individual deals above \$25bn) will increase from the two in 2005 (Gas Natural and Endesa and Telefonica and O<sub>2</sub>). Already in the first six weeks of 2006 we have seen two such deals - EON's \$66 billion bid for Endesa and Mittal's \$25 billion bid for Arcelor.

In Tony's view, the outlook for M&A activity in 2006 remains strong. There is likely to be continued consolidation across every industry in Europe which will continue to act as a driver for M & A activity. Large deals are expected in Consumer, Pharmaceuticals, Energy & Utilities, Telecoms and FIG.

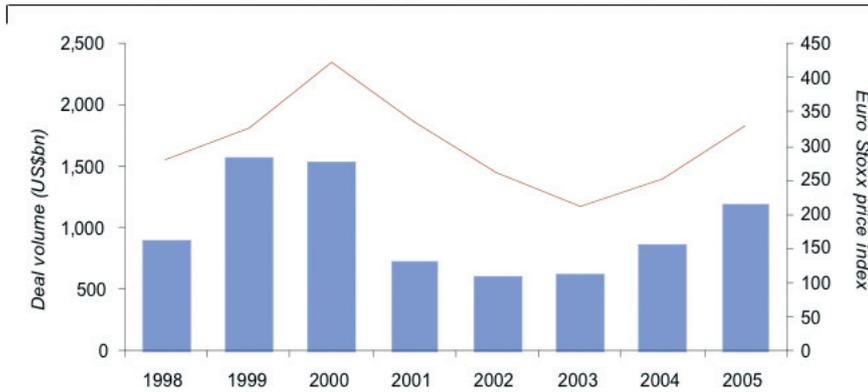
Private equity deals will get much larger, driven by the larger funds raised and the continued availability of cheap debt at high leveraged multiples.

Inter-regional cross-border activity is likely to rise, especially as large European companies make acquisitions in the Americas and Asia.

And finally, hostile activity and contested bids are likely to increase, reflecting competition for the remaining strategic pieces in the pan-European industry consolidation and the increased aggressiveness by private equity, under pressure to invest their new funds.

## The recovery in M&A volumes represents a cyclical upswing

European M&A volumes against stock market performance

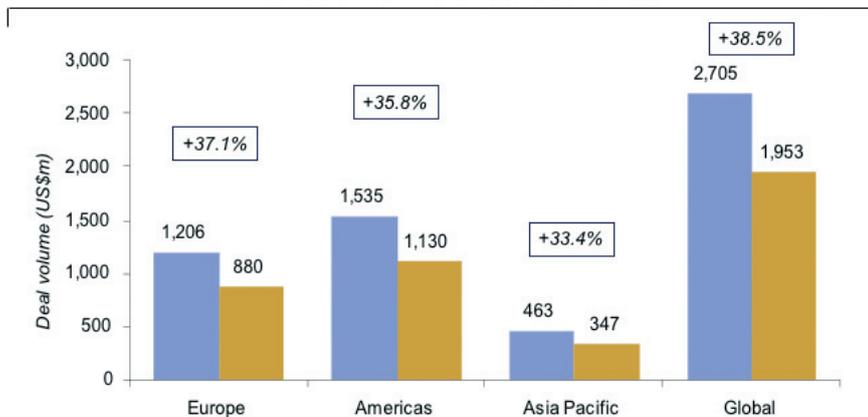


Deutsche Bank 

Note: Based on announced transactions with any European involvement  
Source: Thomson Financial as at 31 December 2005

## M&A volumes were up strongly in Europe in 2005

Announced M&A volumes 2005 vs 2004



Deutsche Bank 

Note: Transactions of any involvement in each region  
Source: Thomson Financial as at 31 December 2005

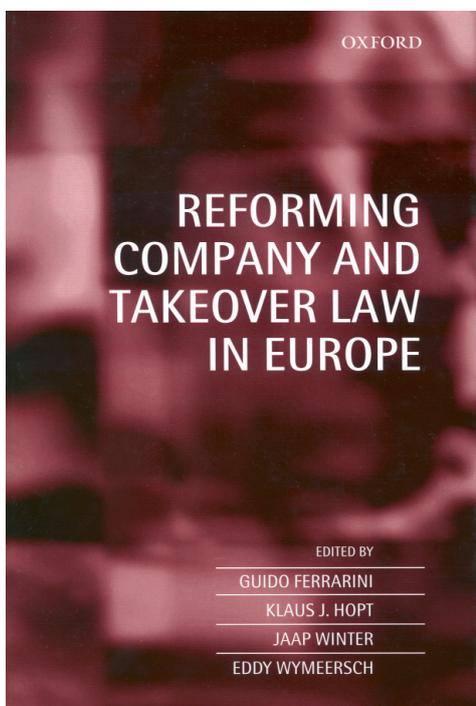
## Book synopsis

### **Reforming Company and Takeover Law in Europe**

*Edited by Guido Ferrarini, Klaus J. Hopt, Jaap Winter, and Eddy Wymeersch*

*Published by Oxford University Press  
ISBN-10: 0-19-927380-4*

*Normal price: £84.00 Discounted Price: £67.20 (see details opposite)*



This impressive work examines the reforms in company and takeover law which are taking place in the UK, Germany, France, Italy and in most other EU member states. The European 13th directive which was enacted in December 2003 requires modifications of member State takeover law. The European Commission's Action Plan on "Modernising Company Law and Enhancing Corporate Governance in the EU" presented on 21 May 2003 will lead to important directives from now until 2010.

This book is the first to deal comprehensively with both the 13th directive and the EU Action Plan, providing commentary on the Action Plan, and critically assessing what the future may hold. The takeover law provisions in the 13th

directive, including the 'break-through' rule and the controversial level playing field for takeover activities amongst European member states and between them and the United States are examined.

The contributions also address a wide range of topical issues including corporate disclosure, board structure, the role of non-executive and supervisory directors, remuneration of directors, responsibility of the management and the board, personal liability of board members, auditors, and conflicts of interest.

The company law action plan and the two reports of the High Level Group of Company Law Experts appointed by Frits Bolkestein and chaired by Jaap Winter upon which the plan was based are reproduced in full in a useful Annex.

## Book Offer

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