The Market for Corporate Control

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Disciplining Mechanisms

• A well-functioning governance system consists of more than just the board of directors and the external auditor.

• It includes all disciplining mechanisms—legal, regulatory, and market driven—that influence management to act in the interest of shareholders. Examples include:
  – Labor market. Failure leads to CEO termination.
  – Capital market. Failure leads to higher cost of capital.
  – Regulatory environment. Violations lead to litigation.

• Similarly, the “market for corporate control” puts pressure on the CEO to perform, or risk sale of company to new owners.
The Market for Corporate Control

• Henry Manne: “The lower the stock price, relative to what it could be with more efficient management, the more attractive the takeover becomes to those who believe that they can manage the company more efficiently.”

• Manne’s thesis is that the price of the stock in part reflects management performance.

• Rather than remove an executive, the board might decide to sell the entire company to new owners who can manage its assets more profitably (e.g., through changes to strategy, cost structure, capital structure, etc.).

• A sale makes sense if the value of firm to new owners (less transaction costs) is greater than value to current owners.

Manne (1965)
The Market for Corporate Control

- The market for corporate control consists of all mergers, acquisitions, and reorganizations—including those by a competitor, a conglomerate, or a private equity buyer.

- The company making the offer is the acquirer (or bidder); the subject of the offer is the target.

- When the target is open to receiving an offer the acquisition is said to be friendly. Otherwise, it is hostile.

- In a tender offer, the acquirer makes an offer directly to the target shareholders to purchase their shares at a stated price.

- In a proxy contest, the acquirer asks target shareholders to elect a dissident slate of directors to approve the deal.
Strategic Reasons for an Acquisition

- **Financial synergies.** The acquiring firm believes it can increase profits through revenue improvements, cost reduction, or vertical integration. This is the logic behind a strategic buyer.

- **Diversification.** Two companies whose earnings are uncorrelated might benefit by relying on the capital generated when one business is thriving to help the other when it is struggling. This is the logic behind a conglomerate structure.

- **Change in ownership.** New owner group might have superior access to capital, managerial expertise, or other resources. This is the logic behind a private equity buyer.
Nonstrategic Reasons for an Acquisition

- **Empire building.** The acquirer purchases a target primarily for the sake of managing a larger enterprise.

- **Hubris.** Overconfidence on the part of management that it can more efficiently manage a target than current owners can.

- **Herding behavior.** The senior management of one company pursues an acquisition because its competitors have recently completed acquisitions.

- **Compensation incentives.** The management of the target company agrees to an acquisition primarily because it stands to receive a large payment upon change in control.

  The average CEO of a large U.S. company stands to receive $29 million in cash and accelerated equity grants following a change in control.

Equilar (2007)
The **Expected** Value of a Takeover

- Research has routinely shown that markets expect the incremental value of an acquisition to flow to the target rather than to the acquirer.

- The target:
  - Receives double-digit takeover premium offer.
  - Experiences greater excess returns in hostile deals.
  - Experiences greater excess returns in all-cash deals.

- The acquirer:
  - Experiences no excess returns following bid.
  - Experiences negative excess returns for hostile bid.
  - Experiences greater declines if equity-financed bid.

The **Realized** Value of a Takeover

- Research has also shown that acquirers realize less value following a merger than originally expected.

- The acquirer:
  - Underperforms peers on a one- to three-year basis.
  - Performs worse if acquisition is financed with equity.
  - Decreases investment in working capital and cap ex.

- Acquisitions are also highly disruptive:
  - They require significant management attention.
  - They lead to elevated turnover rates for up to 10 years following consummation of the deal.

Martynova and Renneboog (2008); Krug and Shill (2008)
Antitakeover Protections

- A company that does not want to become the target of an unsolicited takeover might adopt defense mechanisms to discourage or prevent a bid.

- Antitakeover protections might give a company time to pursue long-term value creation without threat of takeover; or to enhance bargaining power to secure a higher bid.

- Common antitakeover protections include:
  - Poison pill (28% of companies currently have in place)
  - Dual-class shares (8%)
  - Staggered board (50%)
  - Restricted rights to call a special meeting (47%)
  - Shareholders cannot vote by written consent (30%)

SharkRepellent (2009)
Poison Pill

- A **poison pill** grants holders of the company’s shares the right to acquire additional shares at a deep discount to market (e.g., $0.01 per share).
- The poison pill is triggered if a shareholder accumulates an ownership position above a threshold (e.g., 15 to 20 percent).
- If the threshold is exceeded, the market is flooded with new shares, making it prohibitively expensive to gain control.

Markets react positively to adoption of poison pill if company’s board has majority outside investors and negatively otherwise.

Companies that adopt a plan are twice as likely to defeat an unsolicited offer.

If deal is accepted, premium is 5% to 10% higher. But, if deal is defeated, the target’s stock price declines by 14%.

Brickley, Coles, and Terry (1994); Ryngaert (1988)
In a staggered board, directors are grouped into three classes, each of which is elected to a three-year term. Only one class stands for election in a given year.

A corporate raider must win two elections, one year apart, to gain majority representation.

A staggered board brings greater stability to the board; however, it is a formidable obstacle (particularly when coupled with a poison pill).

Between 1996 and 2000, no corporate raider gained control of a staggered board through a proxy contest.

Companies with a staggered board are significantly more likely to defeat a bid.

Companies with a staggered board and that get acquired do not receive a materially higher takeover premium (54% v. 50%).

Bebchuk, Coates, and Subramanian (2002)
State of Incorporation

• A company’s **state of incorporation** is important because state law dictates most governing rights. A company might reincorporate to a state with more protective laws.

• Example of restrictive state law (Pennsylvania):
  – Directors can consider impact of deal on stakeholders.
  – Voting rights are curtailed for shareholders owning > 20%.
  – Short-term profits must be disgorged.
  – Severance must be provided to employees terminated in a deal; labor contracts cannot be terminated.

Shareholders view restrictive state laws negatively.
Companies that opt out of restrictive state law provisions experience positive stock price returns on the day of the announcement.
Companies incorporated in states with high protections do not receive a materially higher offer premium.

Szewczyk and Tsetsekos (1992); Subramanian (2003)
Dual-Class Shares

• A company with dual-class shares has more than one class of common shares; each class typically has proportional ownership interests but disproportionate voting rights.

• The difference between economic interest and voting interest is known as the “wedge”.

• The class with favorable voting rights typically does not trade in the market but is instead held by insiders, founders, or another shareholder friendly to management.

Companies with dual-class shares might have lower governance quality:
• Shareholders are more negative of acquisitions.
• Shareholders are more negative of large capital expenditures.
• CEO compensation is higher (as size of wedge increases)

Masulis, Wang, and Xie (2009)
Summary of Antitakeover Protections

• Below is a summary of defenses by their level of protectiveness, from most difficult to least difficult to acquire.

1. Companies that have either dual-class shares or staggered boards and prohibitions on shareholder rights to call special meetings or act by written consent.

2. Companies with staggered boards but no limitations on shareholder rights to call special meetings or act by written consent.

3. Companies with annually elected boards but prohibitions on shareholder rights to call special meetings or act by written consent.

4. Companies with annually elected boards and full shareholder rights to call a special meeting or act by written consent.

5. Companies with no antitakeover provisions.

Daines and Klausner (2001)
Conclusion

• Research demonstrates that antitakeover protections generally reduce governance quality and shareholder value.

• In evaluating antitakeover measures, shareholders and the board might consider the following:

  1. Does the company require exposure to the capital markets to keep management “in check”? Or, are other governance features sufficient for this purpose?

  2. What are the motives of potential acquirers? Are they consistent with the long-term objectives of the company?

  3. Are antitakeover defenses truly adopted for shareholder protection, or to entrench management?


SharkRepellent. Sample includes 3,875 companies. 2009.


Bibliography


