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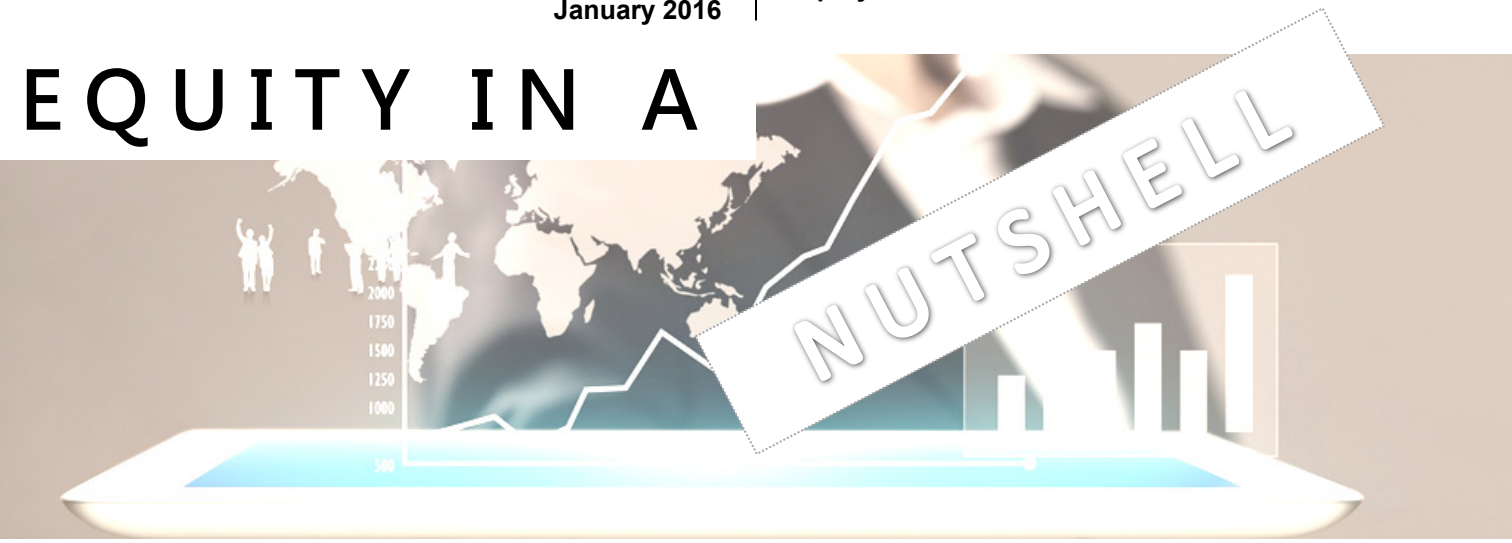
EQUITY IN A NUTSHELL



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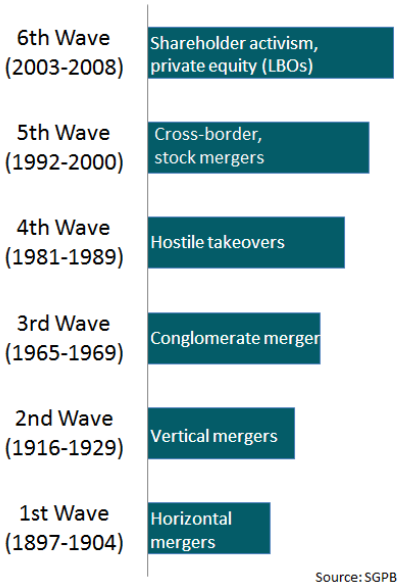
Defensive mechanisms against hostile takeovers

Going public is a critical stage in a company's life, enabling it to raise funds to finance growth, value its assets more accurately and increase its public appeal. However, because of dispersed ownership in listed companies, managers are granted decision-making powers—through the board of directors—and may have different interests from the shareholders' (agency theory). A company becomes an easy target of a hostile takeover when its board of directors considers an offer unwanted but the shareholders are in favour. The more the ownership is dispersed, the more hostile takeovers become an area of concern for the management, necessitating defensive mechanisms against such actions.

Historical context

Of the six M&A waves in the history of equity markets, the fourth in the 1980s saw the biggest peak in 'corporate raids', another term for hostile takeovers. That period coincided with changes in anti-trust regulations, deregulation in the financial sector and easily available financing, which enabled leveraged acquisitions. The collapse of the junk bond market initiated the end of that 'decade of greed'.

M&A waves and their characteristics



Before initiating hostilities

Acquirers either start with a hostile takeover or first attempt a friendly takeover by negotiating with the board of directors. When the board rejects the offer—reasons cited often include the will to remain independent, difference in strategic views, insufficient price, or lack of synergies—the acquirer may abandon the takeover, renegotiate a higher price, or engage in a hostile takeover if it believes that (a) the current management need not be retained in the case of a takeover, or that (b) shareholders could either convince the board to accept the offer or replace the most reluctant members at the next AGM. Rarely do acquirers start with a hostile offer that becomes friendly once the board endorses it.

Three approaches

The goal of a hostile acquirer is to directly address shareholders in order to rapidly build a controlling interest or to make the bid successful.

- ***Tender offer*** consists of a formal offer at a fixed price (above the current market price) made directly to all shareholders, who may or may not accept to tender their shares in a public and regulated process.
- ***Bear hug*** is when the acquirer makes an informal offer to some shareholders with a significant share of the capital in order to gain controlling interest.
- ***Proxy fight*** is the acquirer's attempt to solicit votes from existing shareholders so as to form a majority and elect new board representatives to approve the takeover.

Two categories

Defensive mechanisms against hostile takeovers can be categorised into preventive (pre-offer) and reactive (post-offer) mechanisms.
Pre-offer mechanisms make the company less attractive for a potential acquirer and thus prevent them from launching a hostile takeover. This approach is meant to be quickly dismantled if the offer becomes friendly.
In contrast, post-offer mechanisms reduce the power gained by the acquirer from its increasing interest in the capital after the start of a hostile takeover. Here is a quick summary of the vocabulary attached to both types of defence mechanisms:

Pre-offer mechanisms

• **Restricted voting rights**
This mechanism is straightforward: it prevents recent acquirers of large blocks of shares from obtaining their voting rights before the expiry of a predetermined period.

• **Supermajority voting provisions**
These provisions make it harder for the acquirer to obtain a real controlling stake by requiring a large majority (usually 67–90% of votes) to approve critical changes such as a merger.

• **Staggered board of directors**
A board is staggered when elections of different members occur at different times. Staggering dissuades the acquirer from using a proxy fight as it will take much longer to win it. This practice is common is the US, where only a third of the board is elected at a time instead of all members together.

• **Poison pills**
Poison pills are provisions that increase the cost of acquiring the target's shares. 'Flip-in' poison pills give the target's shareholders the right to buy the target's shares at a discount, thus increasing the hostile bidder's cost of acquiring those shares. 'Flip-over' poison pills give target's shareholders the right to buy the acquirer's shares at a discount in the event of a merger.

• **Poison puts**
Poison puts are a type of poison-pill provision that have a bond covenant enabling holders to redeem a bond before its maturity in the event of a hostile takeover (trigger event). This discourages hostile takeovers as the bidder would need to be able to afford bond repayment in addition to the purchase price.

• **Fair price amendments**
Fair-price amendments obligate the potential acquirer to pay targeted shareholders a floor price determined by a formula based on historical prices. This can discourage hostile takeovers by making them more expensive. Fair-price amendments can also include the obligation to pay the same price to all shareholders.

• **Golden parachutes**
This compensation agreement is widely known as a bonus (often unjustifiably as a guaranteed bonus) rather than as a defensive mechanism. It gives top executives a substantial exit payment in the event of a change of control in order to discourage potential hostile bidders.

• **Use of regulation**
Regulation can be used as preventive defence. In the US for example, some companies choose to be incorporated in states that have more restrictive takeover laws.

Post-offer mechanisms

• **Litigation**
After the board has rejected an offer, litigation is usually the first post-offer defence put in place. Even if the bidder eventually wins the lawsuit (based on a violation of securities law or anticompetitive grounds), litigation at least buys the board some time to renegotiate terms and/or explore other options such as a 'white knight'.

• **White Knight and White Squire**
A 'white knight' is a third-party company that partners with the board and makes a counteroffer in order to 'save' it from a hostile takeover from the bidder or the 'black knight'. Boards seek a white knight to better preserve the company's interests or to negotiate more favourable takeover terms. A 'white squire' is similar, differing only in that it takes a significant minority stake as opposed to a majority stake for a white knight.

• **Crown jewels**
This defence consists in selling those parts of the target company to a third party (activities or subsidiaries) that the hostile bidder considers the most valuable/strategic, thus decreasing the overall attractiveness of the target company.

• **Greenmail**
This portmanteau word between 'greenback' (dollar bill) and 'blackmail' is used to describe the target company's attempt to stop a hostile takeover by repurchasing the hostile bidder's shares at a premium (greenmail payment). Greenmail is also lightly known as a 'bon voyage bonus' and a 'goodbye kiss'.

• **Pac-Man**
Referring to the famous video game where the prey can turn around and pursue its predator, a Pac-Man defence in one where the target company tries to acquire the company that has made a hostile takeover attempt.

• **Share repurchase**
The target company can initiate a share repurchase program in order to push the share price higher and make the ongoing hostile takeover more expensive for the acquirer.

• **Leveraged recapitalisation**
The target company can borrow heavily to finance share repurchases, making itself more risky (and less attractive), in addition to increasing the acquisition cost for the hostile acquirer, thus killing two birds with one stone.

• **Management buyout (MBO)**
This can be a final solution to ward off corporate raiders: the management itself acquires a controlling interest in the company, usually through an MBO transaction (leveraged buyout with a private-equity partner), as a few individuals may not have sufficient funds to finance it.

Conclusion

Success rates of defensive mechanisms against a hostile takeover depend on their number, their efficiency and the corporate raider's determination to acquire its 'prey'.
Investing in companies that are potential targets of hostile bids can be fruitful as corporate raids heighten their share prices. Studies show that such raids are often launched on companies that:

(1) Have poor operating performance (opportunity to maximise profits), necessitating replacement of the current board and management, or
(2) Are undervalued by the market (opportunity to buy shares at a discount).

However, the question of whether hostile acquirers and targets outperform post-execution has no definitive answer.