Geoff Meeks and J. Gay Meeks

The Merger Mystery

Why Spend Ever More on Mergers When So Many Fail?

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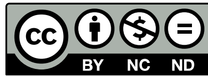

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4. Incentives for Other Participants

> One newcomer to the board under Welch was surprised by the CEO's command of the board room and the sparse debate among the group. Confused by how the meeting transpired, the new director asked a more senior colleague afterward, 'What is the role of a GE board member?'
>
> 'Applause,' the older director answered. (Gryta and Mann 2020, p. 21)

Non-executive Directors

In mergers of smaller businesses, the owner-manager of the acquirer would typically agree a deal with the owner-manager of the target. But in the mergers of larger, listed businesses, on which this book concentrates, there is of course typically a 'divorce' of ownership and control, and the owners of the acquirer and the managers of the target may play only a limited role. The two leading decision-makers in a deal are the acquirer's CEO and the target's shareholders. The former has to persuade the latter to trade their shares for the acquirer's shares, or for cash.

The acquirer's CEO will spend a good deal of time in conclave with her adviser from the investment bank, who will sometimes have identified the target and suggested the acquisition in the first place (see Chapter 3). The target's shareholders will receive advice from the target's board, and, particularly if it is an offer of the bidder's shares in exchange, rather than of cash, will receive information from the acquirer's CEO on the acquirer's record and the prospects for the combined company. Much of this information will have been prepared by advisers in the pay of the acquirer, on the basis of information provided by management.

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As we show in later chapters, the most consistent winners from merger are these three groups: the acquirer's CEO,[1] the acquirer's investment bank and other advisers, and the target's shareholders.

The acquirer's shareholders, on the other hand, have a much smaller role, despite the fact that they will be seriously affected by the terms of the deal and the combination's performance after the merger. Sometimes—for example if the deal requires a large increase in share capital—they may get a vote. And if they cannot challenge the proposal by 'voice'—a vote—they can 'exit': sell their shares. If this occurs on a significant scale it may lead to a fall in share price. And if shares are the currency of the offer, target shareholders may be deterred from accepting. For example, when Couche-Tard bid for Carrefour in 2021, while the target's shares rose by 13%, the bidder's shares fell 10% (Abboud 2021). And the bid was abandoned (Abboud and Kirby 2021).

One other potential channel through which acquirer shareholders might influence the merger decision is through the group of (part-time) non-executive directors (NEDs) on the acquirer's board. They are expected to represent the interests of shareholders. But there is anecdotal evidence that their scrutiny is weak (see the quote at the head of this chapter, and Chapter 11). And—paralleling Chapter 3's discussion of financial advisers—put yourself in their position: is it in their interest to challenge—to make trouble for—a CEO who is set on an acquisition? NEDs of UK FTSE 100 companies were typically paid in the order of £100,000 for their very part-time job in 2020 (four times the average full-time wage in Britain) (Deloitte 2021). Gaining a reputation as a troublemaker who challenges the CEO might not help retain this role or garner other lucrative part-time non-executive positions: around two thirds of those already making 100k (on average) held at least one other directorship (Hargreaves 2019).[2]

Fund Managers

In many cases, the executives of the bidder do not need to get the approval of their shareholders for an acquisition.[3] Mostly the only influence of the

1 And other internal partners of a private equity fund (see Chapter 7).

2 This is not to say that every NED will be driven by self-interested motivation.

3 Listing Rules for the UK Stock Exchange do require a vote by the acquirer's shareholders where target size exceeds a given proportion of the acquirer's size.

acquirer's shareholders on the outcome is through the 'exit' option of selling their shares in the bidder. In a cash bid the acquirer's executives can ignore this; only in a share for share bid might exit affect the outcome (as in the Couche-Tard bid). It is the target's shareholders who reliably have a direct role—'voice'—in the process: the requisite majority must accept the offer if the deal is to proceed.

In practice, the choice of the target shareholder will mostly be exercised not by the person who has invested in the share, but by an intermediary such as a fund manager acting for a pension fund or insurance company.[4] Where does her interest lie? Again, as in the case of the acquirer's CEO and the acquirer's professional adviser, the pay and promotion of pension fund managers is typically linked to performance. And performance is often measured by the quarterly change in the value of the manager's fund.

The bidder typically has to offer the target shareholder a premium over the pre-bid price of the share on the market. This is because the pre-bid price is that which induces the marginal buyer and the marginal seller to trade, and some shareholders, believing the prospects of the target firm are worth more than the pre-bid price, will only sell if they receive at least that higher valuation. The typical premium required to secure control—to persuade enough intra-marginal holders to part with their shares—averages around 30% (Amel-Zadeh and Meeks 2019). If the deal goes through, this is the wealth gain for the marginal shareholder in the target; but for all intra-marginal shareholders, the gain is smaller, and for the last shareholder to agree, very small—had the premium been 1% less, she would not have sold.

But for the fund manager, her portfolio records an immediate gain on the target's shares of the full 30%. And performance-related benefits linked to the fund value will rise correspondingly. She may therefore be willing to sell for a lower premium than those she acts for would require for themselves. Kynaston (2001, p. 673) quotes a fund manager weighing up a bid: '"I will probably accept the Hanson Paper [Hanson shares offered in exchange for United Biscuits shares] because I cannot afford to miss out on short-term performance of shares"'.

And Somerset-Webb (2017) illustrates the misalignment of incentives:

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4 Institutional ownership in the FTSE 100 was reported as 62% by Segerstrom (2020).

> Take mergers and acquisitions. If you are a fund manager holding an investment that attracts a bid at a 40 per cent premium, you'll vote to take it. Can't be bad for the performance numbers on which your bonus is based, can it? But is that what the pensioner, who was enjoying the steady growth in the dividend yield from the same investment, is also likely to do?
>
> Pointing out that short-termism in investment is a problem is not exactly new...

Academic Experts

The acquirers sometimes call at universities, tempting academic experts to lend enthusiastic support to the promoters of a deal. Here, once again, financial incentives tend to be aligned with the acquirer's interests. An academic colleague who was expert on M&A once explained to us that, when a merger was being investigated—and possibly blocked—by the regulator, the pay he would be offered for an hour's work on the promoter's side was roughly equal to that for working a day on the (government) regulator's side. As before, put yourself in his position... But, being public-spirited and content with an economical lifestyle, he resisted these inducements and chose not to work for the highest bidder.