

# **MGST 451**

## **Corporate Governance and Ethical Decision-Making**

**Lecture 19 – Winter 2019 L01-L03**

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You may want to review chapter 28 of the FNCE317 textbook

1. The Free-Rider Problem
2. Toeholds
3. The Leveraged Buyout
4. The Freezeout Merger
5. Earnings Growth Revisited

- A badly managed firm with a depressed stock price is an opportunity for a raider to acquire control, replace management and enjoy a capital gain as stock price recovers.
- If the raider offers to acquire 51% of the shares at the current stock price to acquire effective control, each existing shareholder is better off keeping its shares and enjoy the benefits of the actions of the raider (i.e. a capital gain).
- To convince existing shareholders to sell their shares, the raider might have to increase its offer price to a point where most if not all of the expected profit is captured by the existing shareholders.
- This free-rider problem dissuades raiders to act as above described.

- To avoid the free-rider problem, one could imagine that a raider could buy shares at the depressed price on stock exchanges (since such share purchases are anonymous).
- But, securities laws require a single shareholder (or a group of shareholders acting in concert) once having bought more than a certain percentage, typically either 5 or 10% of total shares outstanding, to make such fact public. Such public disclosure often has to include a statement of intent.
- So accumulating a toehold in pursuit of control is not an entirely effective solution to the free-rider problem.

- Create a vehicle (i.e. a corporate shell) that will be funded mostly with debt for the sole purpose of acquiring the target.
- Acquire target and merge the acquisition vehicle with target.
- The merged entity is almost identical to the target, but with lot more debt and privately-owned by different shareholders.
- Manage aggressively target to increase cash-flow, in order to support debt charges and bring debt lower by repaying it.
- If successful, cash-out through an IPO or sell to highest bidder.
- Many private equity firms specialize in such leveraged acquisitions (LBO) with some success.
- When management is actively involved in a leveraged buyout as buyer, it is called a management buyout (MBO).

# The Leveraged Buyout: Example 28.5

	Stock price	Nb. of Shares	Market Cap.	Debt	Enterprise Value
	\$40	20m	\$800m	nil	\$800m
a) Borrow \$400m, buy 50% of shares, change management, and increase EV to \$1,200m (profit: \$400m)	\$40	20m	\$800m	\$400m	\$1,200m
b) Borrow \$450m, buy 56.25% of shares, change management and increase EV to \$1,200m (but all shareholders will sell!)	\$37.5	20m	\$750m	\$450m	\$1,200m
c) Borrow \$800m, transfer \$450m to firm, retain \$350 of debt, buy 100% of shares at \$40, change management and increase EV to \$1,200m (profit = \$750m - \$350m = \$400m)	\$37.5	20m	\$750m	\$450m	\$1,200m

- Cannot extract more than value created (in above example \$400m)
- In Canada and US, must offer minimum of premerger share price.

- Laws on tender offers often allow the acquirer to force non-tendering shareholders to sell their shares at the tender offer price (as long as the majority or a super-majority of shareholders are agreeable to sell their shares to start with).
- The legal process may vary, but the non-tendering shareholders are left with either getting the tender offer price for their shares or nothing.
- While an LBO requires a cash offer, the Freezeout can be completed with a stock offer (i.e. the acquirer paying with its shares rather than cash), which can be advantageous.

- Let's drill down the constant dividend (Gordon) growth model

$$\text{Price of stock} = P_0 = \frac{D_1}{r_E - g} = \frac{\text{Dividend at time 1}}{\text{required rate of return} - g}$$

- Define growth ( $g$ ) as growth in earnings

$$g = \text{Growth in Earnings} = \frac{\text{Change in Earnings}}{\text{Earnings}}$$

- Change in earnings comes from new investments

$$\text{Change in Earnings} = \text{Investment} \times \text{Return on Investment}$$

- By substitution

$$g = \frac{\text{New Investment} \times \text{Return on New Investment}}{\text{Earnings}}$$

- The payout ratio: the proportion of earnings paid as dividend

$$D_1 = EPS_1 \times \text{payout ratio}$$

- The retention rate is the proportion of earnings not paid as dividends, therefore equals 1 – the payout ratio.

$$\text{New Investment} = \text{Earnings} \times \text{Retention Rate}$$

- By substitution

$$g = \frac{\text{Earnings} \times \text{Retention Rate} \times \text{Return on New Investment}}{\text{Earnings}}$$

$$g = \text{Retention Rate} \times \text{Return on New Investment}$$

- Growth is driven by how profitable the firm is and how much of such profits are reinvested into positive NPV projects.

- The (forward) Price/Earnings ratio and by substitution

$$P/E = \frac{P_0}{EPS_1} = \frac{1}{EPS_1} \times \frac{D_1}{r_E - g} = \frac{D_1/EPS_1}{r_E - g} = \frac{\text{Payout Rate}}{r_E - g}$$

- Two firms with the same payout, same risk and same EPS growth should have the Price/Earnings ratio.
- However, if one firm has an expected growth rate higher than the other and everything else the same, its Price/Earnings ratio should be higher.
- Firms within an industry with an high expected growth rate should have high Price/Earnings ratios. But a given industry cannot grow faster than the economy forever and within a given industry some firms will be winners and some losers.

# Earnings Growth Revisited: Examples

	Share price	EPS	Trailing P/E	Rev. Growth
GM	\$37.22	\$5.53	6.73	2%
IBM	\$140.53	\$9.52	14.76	-3.5%
Alphabet	\$1,223.40	\$43.70	27.99	22%
Facebook	\$165.23	\$21.83	21.83	30%
Amazon	\$1,797.93	\$20.14	89.27	20%

- Per Yahoo Finance (EPS and revenue growth are last year)
- ‘Old-economy’ firms like GM and IBM are experiencing low revenue growth and therefore low EPS.
- ‘New-economy’ firms have higher revenue growth and therefore high EPS. Some firms like Amazon sacrifices EPS in favor of acquisition of market share and get high P/E ratios.



- P/E ratios are cyclical, notably influenced by how enthusiastic investors are, but tend to somewhat mean-revert toward a long-term mean.
- Source: <http://www.multpl.com/shiller-pe/>