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Bond tender offers in mergers and acquisitions

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ABSTRACT

We explore the motives and consequences of bond tender offers announced in connection with mergers and acquisitions (M&A). We find merging firms use bond tender offers strategically to renegotiate with bondholders to gain financial flexibility by reducing leverage and eliminating covenants, and to curtail the coinsurance benefits associated with M&A. Moreover, we find bondholder wealth effects depend not only on the bond's own characteristics, but also on the characteristics of its sibling bonds. Finally, the use of bond tender offers in M&A is associated with increased likelihood of deal consummation and lower acquisition premiums.

1. Introduction

Mergers and acquisitions (M&A) result in both value creation as well as wealth redistribution among target and acquirer stakeholders. Wealth transfers between stock and bondholders have been shown to arise from coinsurance and expropriation, resulting from changes in the value or risk of the assets underlying the bonds.[1] Bondholders may also extract rents from shareholders when bondholders have (some) control over the deal, perhaps via change in control covenants and other restrictive covenants. Shareholders may wish to negotiate with bondholders to mitigate these adverse effects, which if ignored could prevent the deal altogether. Renegotiating with bondholders, however, poses challenges. For example, dispersed ownership and the commensurate hold-out problem make obtaining bondholder agreement difficult. One potential way around this challenge is to use

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[1] For an extensive discussion of wealth transfers in M&A see Lewellen (1971); Higgins and Schall (1975); Kim and McConnell (1977); Lehn and Poulsen (1989); Cook and Martin (1991); Shastri (1990); Israel (1991), and Billett et al. (2004). Relatedly, Warga and Welch (1993) document bondholder expropriation in LBOs while Billett et al. (2010) show that change in control covenants insulate bondholders from expropriation and can actually lead to bondholder gains.

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tender offers which have been shown to be an effective way to negotiate with bondholders, who release their claims at a premium.[2]

We explore how bond tender offers are used in M&A to see how they influence both the probability the M&A completes and the magnitude of shareholder and bondholder wealth effects. Our main findings are 1) bond tender offers occur for bonds that would otherwise likely impede the deal (i.e., those with high coinsurance potential and those with restrictive covenants); 2) bond tender offers associate with an increased probability that deals will complete; 3) bond tender offers associate with lower target shareholder premiums; and 4) the wealth effects to the tendered bond issue depend on the characteristics of other bond issues lacking a tender offer. Taken together our study suggests that the wealth effects to shareholders and bondholders documented in prior studies are dramatically influenced by the use of bond tender offers, and that bond tender offers can effectively alleviate the deterrent effect that debt may have on M&A. Additionally, while prior studies look at bondholders as a group, we show that not all bond issues fare the same, and that the wealth effects and decision to tender for one bond issue depends on its characteristics relative to other (sibling) bond issues.

We investigate merger related bond tender offers using a hand-collected sample of 358 such transactions announced between 1985 and 2008. We hypothesize that tender offers will be more likely and influential when the coinsurance potential of bonds is high and when bonds contain more restrictive covenants — i.e., when they will have more (indirect) control over the deal. Consistent with these conjectures, we find that merging firms with junk rated bonds and with more restrictive bond covenants are more likely to use bond tender offers. Merging firms with junk credit ratings are 48.34% more likely to receive a bond tender offer and those with outstanding bond issues protected by change-in-control (CIC) and other (non-CIC) covenants are more likely to receive bond tender offers. We also find that leverage increasing deals, such as cash deals that increase the merging firms' net debt, are more likely to associate with bond tender offers.

In addition to the deal level analysis, we conduct tests at the bond issue level, which sheds further insights by allowing us to pin down the bond issue characteristics as determinants of shareholders' decision to selectively tender for bonds. We find the probability of receiving a tender offer increases in a bond issue's coupon rate, amount outstanding, and is greater for junk bonds and bonds with more restrictive covenants. Overall the results suggest that, consistent with the deal level analysis, merging firms use bond tender offer to actively manage financial flexibility and are more likely to tender offer for the bond issues with higher coinsurance potential.

Next, we exploit the fact that many firms have multiple bond issues, allowing us to examine bondholder wealth effects holding deal and firm characteristics constant. Bond tender offers are for specific bond issues and often leave other issues outstanding. This means that bond tender offers may influence not only shareholder and tendered bondholder wealth, but also the wealth of bond issues that remain outstanding. Exploring wealth effects at the bond issue level also allows us to see how one bond issue's wealth effect depends not only on its characteristics, but also on the characteristics of its sibling bond issues.

We find that bonds receiving tender offers (*subject bonds*) experience significantly positive excess returns with a mean of 3.47%, while those not receiving tender offers (*non-subject bonds*) experience significantly negative returns averaging −0.65%. Among the subject bonds, the positive excess returns appear to be driven by the target bonds with an average excess return of 6.08%, while the negative excess returns to non-subject bonds are driven by the acquirer bonds. Moreover, we see bonds react differently depending on the timing of the bond tender offer announcement relative to the acquisition. When the bond tender offer is announced before the acquisition announcement, subject bonds (non-subject bonds) experience significantly lower (more negative) excess returns, consistent with shareholders' incentive to neutralize the coinsurance effect at a lower cost pre-merger as conjectured in Higgins and Schall (1975).

Interestingly, we also find that while there may be numerous target and/or acquirer bond issues outstanding, shareholders selectively choose which bond issues will get tender offers, which leads to different wealth effects that depend on the bond issues' characteristics relative to one another. We find bond issue wealth effects depend on the characteristics of the issue receiving the tender offer relative to those that do not. For example, the maturity of the bond issue that receives the offer relative to the maturity of non-subject bond issues has a pronounced influence on wealth effects. Bond issues receiving tender offers experience an excess return of 3.47% return on average; however, this average rises to 7.17% in cases where the targeted issue has a longer time to maturity than bond issues not receiving tender offers. Absent this sort of "priority jump", the bond issue receiving the tender offer experiences an average excess return of 2.28%.

Finally, we explore the impact of bond tender offers on M&A deal outcomes. Consistent with our hypothesis that bond tender offers provide incentive for the shareholders and bondholders to renegotiate so that the deal appeals to both groups, we find that use of bond tender offers is associated with an increased likelihood of deal success and a lower acquisition premium. The lower acquisition premium suggests that wealth gains by specific bond issues come at the expense of shareholders.

Overall our results suggest that bond tender offers play an important role in facilitating M&A and in shaping the wealth effects resulting from M&A. Our results suggest that previously documented bondholder wealth effects in M&A might be largely driven by associated bond tender offers in an attempt to redistribute the otherwise occurring wealth effects between shareholders and bondholders, and between individual bond issues.

The remainder of the paper is as follows. We provide motivation based on prior literature in Section 2. Our data and sample collection procedures and descriptive statistics are described and reported in Section 3. Section 4 presents results from analysis

[2] Mann and Powers (2007) show that bond tender offers are more likely when the firm wishes to remove restrictive covenants and when the bond issue generally contains a greater number of covenants.