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Notes

On the optimality of partial tender offers

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Abstract

This paper analyzes the optimality of partial tender offers in acquisition of firms. We show that partial offers have no impact on the acquirer's expected profit under complete information.

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1. Introduction

Tender offers have been a popular tool of hostile takeovers of publicly held companies, and became especially prominent in 1980s. When a friendly acquisition is not feasible, an acquirer (or raider) may resort to a tender offer, circumventing the target's management and board. The raider may make an offer to any and all shares tendered or structure a *partial offer* so that only a prespecified fraction of all outstanding shares are bid for.[1] In an oversubscribed partial offer, tendered shares are accepted on a pro rata basis.

Partial tender offers may allow a raider to capture control without buying all shares. A raider's main motivation may be private benefits of control as opposed to shareholder value creation. This might be a concern for target shareholders and thus legislators and regulators. The Article 5 (Mandatory Bid Rule) of the E.U. Directive on Takeover Bids, in force since 2006, does not

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[1] A tender offer can also be conditional, usually requiring a successful takeover.

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allow such offers.[2] In contrast, the United States allows partial offers.[3] However, they are not frequently employed.[4]

In this paper, we analyze the optimality of partial offers within the context of the free rider problem in the market for corporate control. In a seminal paper, Grossman and Hart [7] show that each small shareholder has an incentive to free ride and retain his share as long as a value increasing raider buys a majority of shares. We consider a framework that is very similar to that of Grossman and Hart [7]. The main difference is that we suppose that there are finitely many shareholders. A shareholder value increasing raider first decides whether to make an offer for any and all shares or to employ a partial offer. And then he makes a take-it-or-leave-it offer to shareholders who simultaneously make their tendering decisions. The takeover attempt is successful if the majority of shares are tendered.

In our model, the raider optimizes over the fraction of shares she is willing to buy as well as the offer price. In our analysis, we identify two different channels through which the choice of partial offers can affect the expected profit of the raider. First, a partial offer restricts the number of shares the raider can buy in a successful takeover attempt. In that case, if the offer price is lower than the post takeover value, the use of partial offers limits the number of shares bought and reduces the raider's profit.[5] Second, we show that the use of partial offers impacts the shareholders' tendering behavior.

In order to see how the raider can affect the shareholders' tendering decision, consider the problem raider faces. She knows that each shareholder has to balance the fact that not tendering reduces the probability of a takeover but tendering rules out any chance of capturing post takeover value increase. Consequently, a partial offer is more attractive for the shareholders, since each shareholder knows that with some probability some of the shares will be returned to him if a tender offer is successful. Therefore, for any given price, lowering the fraction to be bought reduces the shareholders' incentive to free ride and increases the expected number of shares tendered. More precisely, for any given price the probability of each shareholder tendering increases as the partial offer gets more restrictive.

As we show in our analysis, these two forces cancel out each other exactly. More specifically, when the raider optimizes over both the price and the number of shares she is willing to buy, the use of partial offers has no impact on her expected profit. We provide the intuition once we formally present our main result.

Grossman and Hart [7] showed that it may not be feasible for a value increasing acquirer (or raider) to profitably take over a widely held firm. Bagnoli and Lipman [1] analyzed this problem in a finitely many shareholder setting under symmetric information, i.e., both shareholders and the raider know the amount of value that will be increased due to takeover. They characterized the symmetric equilibrium and showed that as the number of shareholders goes to infinity the expected profit converges to zero.[6] Our setting is very similar to Bagnoli and Lipman [1] model but our key innovation is in allowing partial offers. The other difference is that we do not rule out private benefits of control.

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2 See, e.g., Grant, Kirchmaier and Kirshner [8].

3 Maine and Pennsylvania are two exceptions as they impose restrictions on the use of partial offers.

4 See, e.g., Comment and Jarrel [3].

5 Note that shareholders have no reason to hold on to their shares if the offer price is weakly above the post takeover value. Therefore, the raider never offers a price more than this benchmark. In fact, for any level of private benefits of control and any finite number of shareholders, the equilibrium price must be strictly below the post takeover value.

6 Another paper that involves finitely many shareholders in the form of risk arbitrageurs is Cornelli and Li [5].