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Optimal and efficient takeover contests with toeholds

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ABSTRACT

Target firms often face a takeover threat from raiders with prior stakes in its ownership (toeholds). Previous literature has shown that, when takeovers are modeled as standard auctions, toeholds induce more aggressive bids from raiders, which has two important consequences for the selling process: (i) the board of directors is no longer indifferent about the sale procedure used to get the highest price, and (ii) the target may not be assigned to the highest-value raider. This paper characterizes how the price-maximizing procedure should be in the presence of asymmetric toeholds. Our central result is that the optimal rule needs to be implemented by a discriminatory mechanism quite different from conventional auction formats. By imposing an extra-charge against high-toehold bidders, the optimal mechanism is able to extract more surplus from raiders who bid more aggressively. As a result, nonbidding shareholders benefit unambiguously from the toehold asymmetry. Furthermore, as this bias restores the symmetry in bidders' expected payoffs, the proposed mechanism also allows to allocate efficiently the target among them.

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1. Introduction

Target firms often face a takeover threat from raiders with prior stakes in its ownership (toeholds). For example, Bradley et al. (1988) find that 34% of the bidders in their sample of 236 successful tender offers own toeholds, while Betton and Eckbo (2000) establish that 53% of initial bidders in their sample of over 1300 tender offers (including failed ones) have prior stakes in the target company. More recently, Betton et al. (2009) document that, although toeholds have steadily declined since the early 1980s, they are the norm in hostile takeovers, as more than 50% of this class of takeovers in their sample present bidders with previous participation in the target ownership.

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The presence of toeholds rises interesting questions regarding the selling procedure that the board of directors – or any special committee on behalf of nonbidding shareholders – should use to extract the highest price from the potential buyers. These concerns arise mainly because, when takeovers are modeled as standard auctions, the presence of toeholds introduces additional incentives on raiders to bid more aggressively (Singh, 1998; Bulow et al., 1999).

This more aggressive bidding behavior has two sources. First, unlike conventional auctions, in a takeover contest with toeholds bidders can get a payoff not only when they win, but also when they lose the contest. In fact, since a toehold bidder owns a proportion of the target, losing transforms him into a *seller*. This implies that, conditional on losing, a toehold induces a *more* aggressive bidding behavior. Second, conditional on winning, a toehold also leads raiders to offer higher bids. This is because a prior stake in the target means lower costs of overbidding – by comparison with outside bidders –, as the amount of shares to be bought is smaller.

Toeholds strengthen, therefore, the traditional incentive to increase bids present in any auction, but in this case with the intention to possibly sell at a higher price. Previous literature (see Subsection 1.1) has concluded that, in the context of takeover battles, this more aggressive bidding behavior has two important implications for the selling process.

The first consequence is a break-down of the equivalence of standard auctions in terms of the target sale price they can attain, even when raiders possess symmetric stakes.¹ In such circumstances, non bidding shareholders – by means of the board of directors – should therefore pay special attention to the mechanism used to sell a company. The second implication of more aggressive bids is that the target firm may not be assigned to the highest-value raider. A well-known result is that, under asymmetric ownership structures, conventional auction formats cannot rule out *ex post* inefficient allocations of the target, as the toehold size of potential buyers can play a decisive role in the outcome of the bidding process.

From this, the current paper deals with the issue of how to run a takeover contest in the presence of toeholds from the nonbidding shareholders' perspective. Consequently, we analyze how the maximizing target price mechanism should be and how it could be implemented. In sharp contrast with the existing literature, our work is, to the best of our knowledge, pioneering in that it adopts a *normative* approach rather than a positive one. Thus, instead of taking a particular auction format as given for exogenous reasons, it characterizes how the optimal selling procedure should be. To this end, we construct a model based on the mechanism design approach introduced by Myerson (1981), assuming that each potential buyer derives gains from a particular synergy associated to run the firm. Two main features of our model are the possibility of asymmetry among bidders' toeholds and the existence of a bidder without toeholds (outside bidder).

In this setting, our central result points out that the optimal selling rule needs to be implemented by a procedure quite different from the traditional auction formats frequently used to model a takeover bidding process. In particular, we prove that this implementation is possible through a discriminatory second-price auction with a scheme of asymmetric payments that imposes an extra-charge against raiders with high toeholds.

This discriminatory pricing policy has the following rationale. By imposing a bias against high-toehold bidders, the optimal mechanism extracts more surplus from the stronger players in the game. In the context of takeovers, these advantaged players correspond to raiders who bid more aggressively due to their larger stake in the target. As a result, this non-conventional procedure exhibits two main properties: one relevant from a revenue perspective, and the other with important implications from a social efficiency viewpoint.

The first property of the optimal mechanism is that it pays the seller to adopt its discriminatory pricing rule, as we show that the expected selling price is *strictly* increasing not only in a common toehold (the symmetric case), but also in the degree of asymmetry in these stakes (the asymmetric case). It is worthy to stress that the last property contrasts strongly with the characteristics exhibited by traditional auction formats under the same value and ownership structures studied in the present work. Indeed, whereas we show that at the optimal procedure nonbidding shareholders benefit

¹ This is a classic result in auction theory: the so-called revenue equivalence principle (Myerson, 1981; Riley and Samuelson, 1981).

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