The age of hostility

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The new merger wave may bring more hostile takeovers than ever

THE battle for Cadbury is already turning nasty. One week after Kraft, an American food conglomerate, made an unsolicited bid for it, the British confectioner hit back on September 12th. Roger Carr, Cadbury's chairman, wrote an open letter in which he described the bid as an "unappealing prospect" that would serve only to lock the chocolate-maker into Kraft's "low growth, conglomerate business". Kraft says it is pressing on regardless. It is expected to have to improve its terms to win over Cadbury's shareholders. Officially, Kraft's offer is friendly. Irene Rosenfeld, its chief executive, says she looks forward to "constructive dialogue" with Cadbury. But in reality the moment Kraft made public its rejected offer, the bid became hostile. In this respect, it may mark the start of a trend.

Kraft's offer for Cadbury is one of several recent signs that life is returning to the mergers and acquisitions (M&A) business. Executives and investment bankers have returned from their summer holidays in better spirits, confident that even if recovery may be slow the worst is over for the economy and that credit is becoming available. Share prices, though off their lows, look cheap by historic standards. These are ideal conditions for a new merger wave to form.

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A tempting target

Yet compared with previous waves, the conditions are also far more favourable for hostile bids—perhaps on a scale not seen since, or even surpassing, the 1980s. That was when such deals, often accompanied by predictions of cutting jobs to boost profits, earned themselves such a bad name that a concerted attempt was made to abolish them even in free-market America.

It came close to succeeding, and hostile takeovers became as rare in the 1990s as an underpaid chief executive. Indeed, as recently as 2002, worldwide there were only 15 hostile bids of $500m or more. That number increased from the middle of this decade to a high of 81 in 2006, before plunging along with all other M&A activity (except shotgun marriages of troubled banks) during the economic crisis. This year, as of the end of July, there had been 21 hostile bids.

There are two main reasons why, in the words of a new report by the financial-strategy team at Citigroup, "hostile M&A is poised to surge". The report, "M&A: Hostility on the Horizon", by Carsten Stendevad, Anil Shivdasani and Gavriel Kimyagarov, notes that there has been a sharp reduction in the protections that managers can use to resist a hostile bid. In the 1990s there had been a dramatic increase in the adoption by firms of so-called "poison pills" that could take effect in the event of a hostile bid, such as the ability of the firm to issue vast amounts of shares to friendly investors, thereby greatly reducing the value of shares already bought by the bidder and making the price of buying a controlling stake prohibitively high. Likewise, many firms adopted "staggered boards" in which only some directors (say, one-third of the board) were up for re-election in any given year, making it a long and expensive process for shareholders to vote in a board favourably inclined to a bidder.

However, shareholder activists have in recent years had great success in getting poison pills and other defences against hostile takeovers removed. Proposals to scrap poison pills became a regular feature on annual proxy votes, often garnering the support of enough shareholders to make a difference. According to the Citigroup report, in 2002 some 300 of the companies in the S&P 500 index—in other words, 60% of them—had a poison pill, and 302 had a staggered board. As of July 31st 2009 this had fallen to 94 poison pills (19%) and 164 staggered boards (33%).

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In the aftermath of the economic crisis, low share prices make lots of firms look more attractive as targets than they have been for many years, while the removal of defences makes it increasingly hard to resist a hostile offer. That is why the Citigroup report argues that firms should try harder to make themselves less attractive as targets by, say, doing the sort of restructuring that an acquirer might do, or even reintroducing shareholder defences.

Various academic studies have found that anti-takeover defences seem to pay. The premium of the purchase price over the share price before the bid is higher on average when the target has a poison pill or staggered board than when it does not. Having an anti-takeover defence can allow managers to extract a higher price from a bidder.

This data is likely to be mentioned at every opportunity by company bosses as they now try to restore their defences. However, it will be surprising if they convince many shareholders, as they were mostly already aware of the data when they voted to remove poison pills and staggered boards. Rather than placing their faith in controversial statistical analysis, they preferred a system that made sense to them as owners, by allowing them to sell their firm to a bidder without fear of the sale being sabotaged by the bosses they employ. That is why most companies are likely to remain relatively defenceless, and Kraft's bid for Cadbury will be but one of many in this coming era of hostility.

It remains to be seen whether this wave of hostile bids will turn out any better than those in the 1980s. Many of them ended up in bankruptcy, although their overall effect was to make the economy more efficient, as relatively unproductive firms were taken over and reorganised.

One big positive difference this time, though, is that hostile bids are more likely to be driven by a clear business strategy (such as Kraft's attempt to buy Cadbury to plug its products into the Kraft distribution system) than by the ready availability of debt to "financial" buyers. Although credit markets are reopening, they are not yet ready to lend heavily to private-equity firms. This should mean that there is no immediate repeat of the leveraged buy-out hostile bids of the 1980s, many of which were disastrous and gave the whole business of takeovers and mergers a bad name.