Addressing Value and Dilution Certainty in Business Combinations

The values in a business combination will not remain constant until the closing, and practitioners have developed a number of mechanism to address this uncertainty, including minimum (floor) and maximum (cap) parameters for both the value and number of shares to be issued.

by Clifford E. Neimeth

Allocating price risk between public M&A constituents is a function of innumerable deal-specific considerations. These include the relative bargaining power, stock performance expectations, and risk tolerance of the parties, as well as the overall strategic objectives of the merger.

Although not always king, cash is cash. That is, in an all-cash deal the transaction value remains constant from announcement through closing. Absent a material adverse change affecting the constituents, analysts and investors can readily assess the deal economics and price-based voting decisions are easily made.

However, the transaction value will not remain constant until closing where all or a portion of the deal consideration consists of stock, and pre-closing fluctuations in the purchaser’s stock price presents risks for the parties. A lengthy pre-closing period (complex antitrust problems exist or extensive regulatory approvals are required) or historical purchaser stock volatility, heightens these risks.

If left unaddressed, material changes in the purchaser’s stock price can unduly complicate or derail an otherwise carefully structured business combination. For example:

- A minimum stock value may be required in relation to the aggregate deal consideration, if the stock portion of a hybrid deal is designed to be nontaxable;
- A material erosion in deal value can jeopardize obtaining target stockholder approval;
- A deal that was accretive at the margins when first announced may quickly become dilutive;
- Stock price fluctuations can create subscription imbalances and proration issues in cash/stock election mergers;
- A precipitous decline in the purchaser’s stock price could result in the issuance of more than 20 percent of its outstanding stock and require stockholder approval of such issuance;
- A significant and sustained price decline after signing could trigger the target’s assertion of material adverse change (MAC) termination rights or require renegotiation of the deal;
- The target’s board may be compelled to withdraw its deal recommendation;
- The target board may require a new fairness opinion, if the transaction was priced at the low end of the target’s valuation range; and

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• The transaction may become vulnerable to interlopers, if the deal premium declines significantly.

From the purchaser’s perspective, certainty of accretion/dilution is key. At the risk of oversimplification, in a 100 percent stock-for-stock merger if the (per share) price-to-earnings (P/E) multiple paid by the purchaser for the target’s incremental after-tax earnings (as adjusted to reflect pro forma merger synergies and cost savings) is less than the purchaser’s P/E multiple, the transaction will be accretive to the purchaser’s earnings per share (EPS) and its stock price should not decline. Conversely, if the P/E multiple paid for such earnings exceeds the purchaser’s P/E multiple, the transaction will be dilutive. For this reason, the purchaser typically will negotiate for a fixed exchange ratio at signing, whereby (based on the purchaser’s then-current stock price and the per share premium to be paid) each target share is exchanged for a whole or fractional number of purchaser shares without value formula adjustments. For example, the merger agreement simply can provide that each outstanding target share will be converted into the right to receive “X” shares of purchaser stock. Here, the target’s stockholders have unlimited value exposure if the purchaser’s stock price declines materially before closing.

Conversely, the purchaser is at risk of paying more than the nominal value per target share (agreed to at signing) if its stock price increases materially. An unprotected decrease so substantial that it compels the target’s board to withdraw its deal recommendation and jeopardizes obtaining target stockholder approval, is a significant risk for both parties to take. However, purchasers often take the position that they can always offer to increase the consideration and keep the deal alive if the situation so dictates. Most purchasers will assume the overpayment risk inherent in a fixed exchange ratio to lock in dilution certainty and because a sustained stock price increase is evidence of better-than-anticipated financial results and other positive developments.

From the target’s perspective, certainty of the deal premium to be delivered at closing is the paramount commercial objective and fiduciary concern. A fixed exchange ratio at signing is not optimal and the target prefers a more value-driven approach. With a share value formula, the parties agree at signing to a fixed, nominal value per target share, and the precise number of purchaser shares to be issued in the merger is determined by dividing such value by the average closing price of the purchaser’s stock (ACP) for the 15 or 20-consecutive trading day period ending on or just prior to the closing date or the target’s stockholder meeting. In this way the number of shares to be issued is based on the value of the purchaser’s stock at a time much more proximate to the date the target’s stockholders will be paid the merger consideration. However, because the number of shares to be issued is indeterminate until the ACP is known, a material erosion in the purchaser’s stock price poses significant dilution risk because the purchaser will be required to issue a much greater number of shares.

Collars (Floors and Caps)

To address the value and dilution uncertainties associated with a fixed exchange ratio and an open-ended share value formula, the parties often negotiate minimum (floor) and maximum (cap) parameters for both the value and number of shares to be issued in the merger. There are many permutations that can be engineered to fit a broad spectrum of transaction and other commercial objectives. The concepts are simple, but the mechanics can be complex in the case of cash/stock election mergers with elaborate oversubscription procedures, proration formulae, and equalization or “top up” features. Unfortunately, these cannot be addressed succinctly given the space constraints of this article. However, the most common and simple device, the “collar,” is discussed.

Simply stated, a collar imposes both a floor and a cap on the stock portion of the deal price. It enables the parties to predetermine and better allocate their post-signing risk tolerance. There are two fundamental types of collar: (1) the “fixed value collar;” and (2) the “fixed share collar.” These really are flip sides of the same coin—the former being seller-oriented and the latter being buyer-oriented. With a fixed value collar, the parties negotiate a range of purchaser stock prices (reference prices) within which the purchaser agrees to issue a constant dollar value of its stock for each share of target stock to be converted in the
merger. The exchange ratio floats (adjusts) within the range of reference prices and becomes fixed (constant) outside the collar (i.e., at all prices above the highest reference price, and at all prices below the lowest reference price). With a fixed share collar, the parties negotiate a range of reference prices within which the purchaser agrees to deliver for each target share a fixed number of shares, irrespective of their value. Accordingly, the deal value fluctuates directly in relation (corresponds) to increases and decreases in the purchaser’s stock price and the exchange ratio floats outside the collar.

In each case, the collar width (e.g., 10 percent, 15 percent, or 20 percent, etc.) is based on the maximum appreciation or diminution in the purchaser’s stock price anticipated by the parties. In a so-called symmetrical collar, the purchaser’s current stock price at signing is the collar midpoint (i.e., it is equidistant from the highest reference price and the lowest reference price). However, based on impending corporate developments, unrelated transactions involving the issuance of the purchaser’s equity, the potential for arbitrage activity, the anticipated market reception of the deal, and a variety of other factors, collars are not always symmetrical (and one of the parties will negotiate for greater upside or downside protection).

Illustration of Fixed Value Collar (Floating Exchange Ratio)

Inside the collar the exchange ratio increases (i.e., more shares are issued) correspondingly with reference price decreases, and decreases (i.e., fewer shares are issued) correspondingly with reference price increases. For maximum protection of value, the target will negotiate for a wide percentage collar. The inverse relationship of the exchange ratio to the reference prices assures constant payment of the nominal value per target share within the collar. The parties have no risk of value diminution or overpayment, but the purchaser experiences dilution to the extent of reference price decreases.

Outside the collar, the parties assume value risk, but the purchaser has no further dilution risk because the exchange ratio (i.e., the number of shares to be issued) is capped. That is, at all purchaser stock prices below the lowest reference price, the exchange ratio remains fixed at the ratio corresponding to the lowest reference price. As the purchaser’s stock price continues to decrease below the lowest reference price, the target’s stockholders receive stock currency having a value progressively lower than the nominal value. But, at all purchaser stock prices higher than the highest reference price, the exchange ratio remains fixed at the ratio corresponding to the highest reference price and the target’s stockholders receive a windfall because the purchaser pays with stock currency increasingly more expensive than the nominal value.

To illustrate, assume the parties agree that the target will be acquired in a 100 percent stock-for-stock deal at a 15 percent premium over its $20.00 unaffected stock price, and that the purchaser’s current stock price is $30.00. Therefore, the nominal value is $23.00, with a corresponding (implied) exchange ratio of .76670 ($23.00 ÷ $30.00).

Although a lengthy regulatory approval period is anticipated, neither party expects the purchaser’s stock price to increase or decrease more than 10 percent before consummation of the transaction. The parties agree to a 15 percent (↓/↑) symmetrical, fixed value collar ranging from $25.50–$34.50, with $30.00 as the midpoint.

Inside the collar, the implied .76670 exchange ratio adjusts (⇌), as necessary, to ensure that at all reference prices $23.00 worth of the purchaser stock’s will be issued for each share of target stock.

For example, at a $32.00 reference price, the exchange ratio decreases to .71875 ($23.00 ÷ $32.00). If, however, the reference stock price is $27.00, the exchange ratio increases to .85185 ($23.00 ÷ $27.00). At all prices above $34.50 and at all prices below $25.50, the exchange ratio remains fixed at .66670 ($23.00 ÷ $34.50) and .90196 ($23.00 ÷ $25.50), respectively. Thus, as the purchaser’s stock continues to fall below $25.50, the target’s stockholders progressively receive less than $23.00 worth of the purchaser’s stock (i.e., the nominal value), and at all prices above $34.50 the purchaser issues stock worth progressively more than the $23.00 nominal value.
Illustration of Fixed Share Collar (Floating Value)

Inside the collar the exchange ratio remains constant in relation to reference price increases and decreases. Accordingly, as the reference prices decline the target’s stockholders receive purchaser stock worth progressively less than the nominal value, but as the reference prices increase, the target’s stockholders can receive a windfall. To minimize its value exposure, the target will negotiate for a narrow fixed share collar because although the exchange ratio progressively increases below the lowest reference price, the target’s stockholders will always receive the value per target share associated with the lowest reference price.

At the same time, the purchaser’s “overpayment” exposure is capped, because at all prices above the highest reference price, the exchange ratio progressively decreases to ensure that the purchaser does not pay more than the value per target share associated with the highest reference price.

To illustrate, assume that purchaser and target have agreed-in-principle to a 60 percent cash/40 percent stock transaction at a 16.5 percent premium over target’s $30.00 unaffected stock price and that purchaser’s current stock price is $25.00. Thus, the nominal consideration is $34.95, consisting of $13.98 worth of purchaser stock and $20.97 of cash consideration. The fixed exchange ratio is .55920 shares of purchaser stock for each share of target stock ($13.98 ÷ $25.00).

Because of other pending transactions involving the issuance of the purchaser’s stock, and because the acquisition of the target is expected to be dilutive for the first 12 months after closing (i.e., until operations are fully integrated and maximum synergies are achieved) purchaser believes that its stock price is unlikely to rise materially before closing. In fact, both purchaser and target have been advised that the market overhang from the combined transactions could depress the purchaser’s stock price by 7.5 percent to 10 percent. Purchaser wants the ability to cap or estimate with near-certainty any potential dilution and informs target that it requires a fixed share collar. Seller is very concerned with assuring the nominal deal value and negotiates hard for a fixed value collar. Believing it previously “left something on the table” and after further negotiations, the purchaser agrees to increase the aggregate deal price from $34.95 to 36.00 (i.e., $14.40 worth of purchaser stock and $21.60 in cash), which now represents an approximately 18 percent premium to the target’s $30.50 unaffected stock price (which increased during the week the deal was recut). The parties agree to a narrow 7.5 percent (↓/↑) symmetrical, fixed share collar ranging from $23.125 to $26.875 surrounding purchaser’s $25.00 current stock price (which has remained constant).

The fixed exchange ratio inside the collar is now .57600 ($14.40 ÷ $25.00). The target’s maximum value exposure is 7.5 percent (i.e., coincident with the collar width), because although the exchange ratio progressively increases at all purchaser stock prices below $23.125, each target share always receives $13.32 worth of the purchaser’s stock ($23.125 x .57600). For example, at $21.90, the exchange ratio would increase from .57600 to .60822, but $13.32 worth of purchaser stock is issued for each target share ($21.90 x .60822). Accordingly, the target tolerates up to $1.08 of lost value per target share. Put another way, the fixed share collar has provided the target’s stockholders with a $1.08 per share “stop loss” in relation to the $14.40 nominal value.

Reciprocally, at all prices above $26.875, the purchaser is protected against issuing stock having a value of more than $15.48 per target share. For example, at $28.25, the exchange ratio would decrease from .57600 to .54796 ($15.48 ÷ $28.25). Thus, the fixed share collar also has provided the purchaser with a $1.08 stop loss.

Termination Rights Outside the Collar

Although price-based termination rights are not commonplace in merger agreements, the target may seek the right to terminate the merger agreement if the purchaser’s stock price falls significantly below the lowest reference price of a fixed value collar. This is a means to “stop the bleeding.” The termination right is rarely automatic. Usually the target is required to notify the purchaser of its intention to terminate and the purchaser then is allowed a short
period of time to elect to reset the exchange ratio and increase the deal consideration. In addition, the merger agreement may provide that the target cannot provide a termination notice unless the purchaser’s stock price falls by an absolute percentage below the lowest reference price and such decline also exceeds by a certain percentage an index price of industry peer stocks. In effect, this two-prong measurement assures that the reasons for the purchaser’s stock price decline are purchaser-specific.10

To cap its potential overpayment exposure, the purchaser may seek a reciprocal termination right if its stock price rises significantly above the highest reference price of a fixed value collar. It may also seek the right to walk if its stock price falls significantly below the lowest reference price in a fixed share collar because it may not desire to issue more than a certain percentage of its market capitalization. To prevent the purchaser from automatically walking in these circumstances, the merger agreement can require advance notice to the target and the right of target to waive the receipt of more than a maximum exchange ratio (i.e., number of purchaser’s shares).

In lieu of specific priced-based walkaways, the target’s stockholder vote often is the best referendum on whether a deal continues to make economic sense. Of course, the target’s board may be obligated as a fiduciary matter to withdraw its deal recommendation and communicate to the stockholders that the transaction is no longer advisable. Depending on the circumstances and the terms of the merger agreement, the foregoing may trigger the payment of break-up fees to the purchaser.

Conclusion

As is evident from the foregoing discussion, there are many price mechanisms that public M&A attorneys and financial advisors can design to mitigate the many price-related concerns and issues that may arise after signing in a merger involving the issuance of the purchaser’s stock. There is no standard blueprint to fit all scenarios. Factors such as the percentage cash/stock mix (in a hybrid transaction), the transaction rationale (merger of equals, sale of control, strategic business combination, etc.), the respective market capitalizations of the constituents, the anticipated dilution or accretion, the intended tax treatment of the deal, the purchaser’s historical price performance and volatility, the anticipated preferences of the target’s stockholders in a cash/stock election transaction, avoiding purchaser stockholder approval, protecting against deal jumpers, the relative bargaining leverage and risk tolerance of the parties, and anticipated market perceptions of the deal and arbitrageur activity, will all influence and often dictate price structures.

The key, therefore, is to carefully identify the strategic objectives of the deal, anticipate all of the inherent (or likely) value and dilution risks, and make appropriate use of the extensive pricing mechanisms available to provide the parties with greater certainty.

NOTES

1. As used herein, the nouns purchaser, target, seller, M&A constituents and the like, and the phrases merger, acquisition, business combination and similar expressions, are not intended to denote categorical distinctions in the tax, accounting, consensual vs. unsolicited transaction, or director fiduciary sense. The author recognizes that such phraseology has precise connotation in various contexts, but such terms have been used herein more loosely.

2. In a blended transaction, the risk is not dollar-for-dollar, but instead, corresponds to the percentage of aggregate deal consideration represented by the stock portion. Accordingly, when the consideration consists predominantly of cash and only a small portion of the purchaser’s stock will be issued, the parties are less apt to be concerned over appreciation or diminution in the purchaser’s stock price.


4. Without an express price-based walkaway right, it will be difficult for the target to successfully use a standard MAC clause for a purchaser stock price decline. MAC outs are not often invoked, and then, usually only in situations involving a very substantial, unforeseen and long-term reduction in the purchaser’s earnings or an event causing material, sustained deterioration in the purchaser’s assets or business operations.

5. This depends on the provisions of the merger agreement. The target routinely negotiates for the unrestricted right of the target’s board to withdraw its deal recommendation if, in good faith and on the advice of counsel, it determines that it must do so to comply with its fiduciary duties. The purchaser nonetheless may limit such right to circumstances in which an unsolicited “superior offer” emerges. Such withdrawal, in itself, or when coupled with a failed stockholder vote, typically constitutes a break-up fee event.

6. Therefore, the more shares the purchaser issues, its EPS and P/E multiple will decline. The foregoing is more complex when hybrid consideration is paid, the cash price is funded with external debt, and the size of the market capitalizations of the purchaser and the target are materially disproportionate.
7. A fixed exchange ratio is the norm in a MOE. This is so because a precise percentage ownership in the newly combined company is often desired, and more so, because an MOE typically is priced “at the market” (i.e., no change-in-control premium is paid to the stockholders of either business combination partner) and the exchange ratio is derived principally from each party’s respective revenues, assets, market capitalization, and overall financial contribution to the newly combined company. Moreover, because an MOE is designed as a combination of strategic partners, the stock prices of the constituents tend to trade in tandem after the initial deal announcement and a fixed exchange ratio with reciprocal value risk makes sense.

8. Much less commonly, the formula can blend several measurement periods to derive a more efficient purchaser stock price. In one transaction involving the author as target’s counsel, the formula consisted of a weighted ACP for the consecutive (1) five-trading day period preceding the public announcement of the transaction, (2) a 15-trading day period commencing on the effective date of the registration statement, and (3) 20-trading day period ending on the second day prior to the closing date.

9. After requisite regulatory and stockholder approvals have been obtained and the closing date approaches, the purchaser’s stock price may decline temporarily if a significant percentage of its market capitalization will be issued in the merger. This is why the purchaser typically prefers the measurement period to end prior to the target’s stockholder meeting so it can commence market purchases of its stock to offset any decline caused by short-sellers and arbitrageurs. Issuer hedging activities are subject to a variety of federal securities law restrictions a discussion of which is outside the general scope of this article.

10. The “double trigger” functions in much the same way standard material adverse change out clauses carve out conditions and events affecting an entire industry or the economy generally to the extent not disproportionately suffered by the party against whom the MAC is asserted.