



The previous chapters showed how standard corporate management can be carried on through knowledge of corporate finance tools and issues and how to exert the standard functions of corporate management.

Beyond that, there is a range of operations and actions involving extra skills and knowledge, which are still very important for the life of the business and must be taken into account for daily activity.

Mergers and acquisitions resemble the need for a business to expand both in terms of magnitude and in terms of the range of the activities to be performed. In this sense it entails the need of the corporation to survive through diversification.

For this purpose, knowledge of the corporate governance is also important, in that management is the key to success and it is crucial to acquire knowledge about the governance structure of any corporation.

Among the many functions of management, for the correct development of corporate core business, risk management is among the key functions to be addressed for a successful and profitable business life.

All of these topics are of primary importance in order to complete the picture about how the corporation interacts with markets and how the value creation principle of good corporate finance can be achieved.

After studying this chapter you will be able to answer the following questions, among others:

- What is a merger or acquisition and what is the process for it?
- How does a hostile takeover take place and how can a firm defend itself against it?
- What is corporate governance and how do concepts like management failure and remuneration schemes impact the daily life of the company?
- How can corporate risk management be defined and what are the methods of identification and mitigation?
- What are the possible risk response strategies available to the firm?

The first section of the chapter focuses on the concepts of merger and acquisitions, with insights on the process behind it and the concept of hostile takeover and defense. The second section deals with corporate governance, explaining the management failures and remuneration schemes influencing the behavior of management. The last section is about risk management with the description of corporate risk, the process for identifying and mitigating it, and the possible response strategies.

14.1 Mergers and Acquisitions

Learning Outcomes

- Understand the reasons behind a merger.
- Explain the process of merging and acquiring.
- Define hostile takeover and defense measures.

14.1.1 Reasons for a Merger

In corporate finance, a merger is a combination of two or more companies into one new institution. An acquisition is very similar, with the only difference being the way in which the combination of the two companies is brought about.

In the process of merging or acquiring, the settlement can be done with cash, but in some cases the acquirer may offer either cash or its own shares in exchange for target shares.

Cash transactions offer shareholders an immediate potential profit, whereas shares offer a longer-term investment. Share transactions tend to be more attractive to shareholders in a buoyant market as the value of the shares is likely to increase more rapidly than in a stagnant market.

The reasons for a merger are various, and companies choose such a strategy based on many factors. From common literature findings, there are several rationales and drivers motivating a merge.

The rationales identify the particular framework of thinking that leads to the conditions under which a decision to merge could be made. On the other hand, the drivers represent mid-level-specific influences, from financial to operational, that contribute toward the justification or otherwise for a merger.

A company, for example, may decide to acquire another company for implementing an expansion strategy (and that qualifies as the rationale). In the specific, over- or under-capacity may justify the operation. As an example of driving factor, consider, for example, the desired capacity control in a specific sector.

It is very important to illustrate the main differences between a merger and an acquisition, because the two terms may sound very similar, and it is very easy to be confused.

First of all, consider that the word merger has a strictly legal meaning and is not related to how the merged companies will operate in the future and how the resulting company will be managed.

In a merger, a company combines with another, disappearing into another corporation. All mergers are statutory, meaning that they occur as specific formal transactions in accordance with the regulation of the states where the companies are incorporated.

On the other hand, an acquisition is the process by which the stock or assets of a corporation are owned by a purchaser. The transaction may take the form of a purchase of stock or a purchase of assets.

As one can imagine, the difference between a merger and an acquisition is not that clearly distinguishable. Sometimes in fact both terms are used as synonymous, but there is a slight difference between them.

In a merger there are two companies that form a new company together. After a merger, the separately owned companies become jointly owned and get a new single identity. The stocks of the two originating companies are surrendered, and new stocks in the name of the new entity are issued.

A merger usually involves two companies of similar size, in which case the operation is defined as a merger of equals. In the case of an acquisition, however, one firm takes over another and establishes its power as the single owner.

In an acquisition there is usually a bigger and stronger company taking over a smaller and weaker one. The relatively less powerful smaller firm loses its existence after acquisition, and the firm, which takes over, runs the whole business by its own identity.

In the process of acquisition, there is no surrendering of the stocks of the acquired firm, but they continue to be traded in the stock market. In reality the difference is very little and subtle.

The acquiring company, even if bigger than the acquired one, usually tends to announce the process as a merger anyway. Although, in reality an acquisition takes place, the firms declare it as a merger to avoid any negative impression.

Another important difference is that a merger is based on friendly terms between the companies involved, while the acquisition is an unfriendly deal where the stronger firm inglobates the target firm, even against its will to be purchased.

In particular, when an acquisition is “forced” or “unwilling,” it is called a takeover. In a takeover, the management of the “target” company does not agree with their target company being taken over.

That case is different from the one when managements of both companies agree both mutually and willingly, in order to proceed to the acquisition. In this case it is called simply acquisition or a friendly takeover.

Consider in that respect that an acquisition or takeover does not necessarily entail full legal control. A company can also have effective control over another company by holding a minority ownership.

The process for merging or acquiring is relevant to the overall profitability of the operation. In fact, the process of merger and acquisition can heavily affect the benefits derived out of the merger or acquisition. This is why the process should

be designed in a way to ensure the maximization of the benefits of a merger or acquisition deal.

Technically, the process for mergers and acquisitions is made of several steps, in order to ensure the implementation of the operation in light of profitability for the acquiring company.

First of all, a preliminary assessment of the target value must be performed, in order to grasp its market value. Such a step involves the assessment of the current financial performance of the company, as well as the estimated future market value.

The second phase is the proposal, which is made after careful review of the target's financials is made. Generally, this proposal is given through issuing a nonbinding offer document.

At acceptance of the proposal by the target company, the exit plan phase plans for the right time to exit and be absorbed by the acquiring company. The choice is between full sale, partial sale, and others. The firm also does the tax planning and evaluates the options of reinvestment.

After the exit plan is finalized, the target firm operates a structured marketing plan in order to achieve the highest possible selling price. In this step, the target firm concentrates on structuring the business deal.

Rationales

The types of possible rationales for a merger or acquisitions can be classified according to the purpose they underlie. The strategic rationale, for example, provides a set of strategic objectives.

The abovementioned need to secure control of capacity is an example of strategic rationale. It is common in fact for a company that wants to enter a profitable market, but does not have the know-how to do it, to acquire a well-established company in the field.

Such a strategy allows the acquiring company to penetrate the new market through the acquired company, without the need to develop the technology and research needed in order to do it.

Developing a research and development division in the new market products in an attempt to catch up and overtake the more established players would in fact have obvious cost and time implications.

Another way to look at the strategic rationale is from a defensive point of view. Generally, in a business environment characterized by many mergers of companies in a particular sector, not merging would be a disadvantage.

A non-merged company may be pressured into merging with another non-merged company in order to maintain its competitive position. This is what happens in strategic sectors populated by very big players.

This is the case of the oil sector, where in the past it became a common strategy for the big companies in the sector to merge and create even bigger corporations. In this way few super-companies were created.

In this type of industries, the merger wave is usually driven by a need to respond to the merger activities of competitors and preserve the market share by enlarging the magnitude of the business, on a comparable scale with competitors.

Another type of rationale is named speculative, and it happens when the company to be acquired is intended as a sort of commodity. The acquired company could be, for example, a start-up in a new and developing field.

If the management of some company targets the company to be acquired as a source of potential profitability in the new field, the acquisition would give the benefits of exploring a new business area without directly being involved in it.

One way to achieve this is to buy established companies, develop them, and then sell them for a substantial profit at a later date. This approach is clearly high risk, even if the targets are analyzed and selected very carefully.

When performing a merger, the acquiring company may face the risk of loss of human capital. It is not uncommon in fact that a significant proportion of the highly skilled people who work for the target may leave the firm.

This can happen either before, during, or immediately after the merger or acquisition, and it is particularly true for small companies operating in highly specialized and technological fields.

In case the loss of specialized workers and managers is significant, the target company may lose a large share of its value, for the acquiring company, making the merger a less successful operation than initially expected.

There are several forms of speculative rationale, and another common one is the merger in view of splitting. This happens when the acquirer purchases an organization with the intention of splitting the acquired organization into pieces and selling these, or major parts of them, for a price higher than the cost of acquisition.

The speculative rationale is also high risk in that it is very vulnerable to changes in the environment. Apparently attractive targets, purchased at inflated (premium) cost, may soon diminish significantly in value if market conditions change.

Another type of rationale that can drive the decision of going for a merger is the management failure rationale. This happens when the acquiring company experiences management failures.

The management of a company decides for the right strategies to implement in the interest of the business. If the strategies are assembled with errors in alignment, or it is the case that market conditions may change significantly during the implementation timescale, the original strategy becomes misaligned.

In case of management failure, the company is no longer able to pursue the planned targets, and a huge variance is experienced in strategy. This can be due to many factors like customer demand, competitors, etc.

When the variance is so high that it is not possible to produce an endogenous change of direction for the business profitability, the only choice left is to acquire a company that will assist in correcting the variance.

Other rational types include financial necessity rationale, when financial reasons are at the basis of a merger. Sometimes, when a company loses momentum and trust from investors, a way to get rid of troubles is to merge with a more successful company.

Political rationale on the other side defines the impact of political influences in mergers and acquisitions, an expanding phenomenon in the world. In the last decade,

many countries experienced the merger of a number of large government departments in order to rationalize their operations and reduce operating costs.

Government policy also encouraged some large public sector organizations to consider and execute mergers. These policies resulted in the merger of several large health trusts and universities among others.

Also big banks have been given incentives to merge domestically and also to embark on an aggressive overseas acquisitions policy. The international aspect is particularly true for those institutions prevented by domestic legislations to directly merge with each other.

Drivers

One of the drivers for a merger is the need of specialized human capital and resources, which leads a company to look for another company to acquire in order to absorb the specific skill or resource owned by the other company.

It usually happens in the framework of a big company targeting a smaller one, with the latter having developed some high-value specific skills over a number of years and where it would take an acquiring company a long time and a great deal of investment to develop these same skills.

In times of booming or recessing markets, the value of the shares of an acquiring company becomes another important driver, in that valuable shares can be used as a mean of payment for the merger or acquisition.

On the other hand, when a company experiences a sensibly low value of its shares, it becomes an appealing target for other companies that want to acquire, therefore becoming very attractive for a cash purchase.

Globalization of economies and markets is another driver that encourages mergers, due also to the growth and development of IT. In the modern era, the geographical distance and separation between companies in fact hinder good business.

Organizations have the incentive to work together as single entities, both within the same countries and across international boundaries, making it easier to access new markets. One way to achieve that is of course through international merger and acquisitions.

As a driver it is also worthwhile to mention consolidation, as both national and international levels, of compatible companies that are available for merger in the same local or international area.

Diversification is another important driver for the companies that want to diversify their business by entering new areas or sectors, in order to balance the risk profile of their investment portfolio.

It must be said in that sense that several studies by reputable scientists show that this type of diversification does not effectively reduce the risk profile of the corporation, given the assertion that the more diversified an organization is, the less it has developed the specific tools and techniques to face specific issues relating to any one of its range of business activities.

Among other drivers it is worthwhile to mention:

- Industry pressures, in specific sectors and specific time periods.
- Capacity reduction, so that the merger leads to increased control on a sector output.
- Vertical integration, with the merger of supplier and customer, etc.

14.1.2 The Process of Merging and Acquiring

According to the type of companies involved and the framework of involvement, several types of mergers can be identified, all of them resembling the different rationales and drivers guiding the process.

It is possible to talk, for example, about horizontal mergers when two or more companies operating in the same business sector decide to merge. The companies run the same type of business.

The main purpose of this merger is to obtain economy of scale in production by eliminating duplication of facilities, reduction of competition, reduction of cost, and increase in share price and market segments.

There are some competitive issues attached to a horizontal merger. First of all, when the companies merge, competition is eliminated to an extent that can be significant, if the companies are big.

Moreover, the combined operations of the merging firms may create substantial market power and could enable the merged entity to gain a monopolistic position and therefore raise prices by reducing output unilaterally.

Finally, there is an issue of concentration of the market players other than the merged firms. The transaction may in fact strengthen the ability of the market's remaining participants to coordinate their pricing and output decisions.

Vertical mergers involve companies that operate at different stages of the production and distribution process of the same good.

The main objective is to increase profitability by the previous distributors. When a company combines with the supplier of material, it is called backward merger, and when it combines with the customer, it is known as forward merger.

The main benefit of a vertical merger is the integration of the production chain, with subsequent internalization of all transactions between manufacturer and its supplier or dealer and the conversion of a potentially adversarial relationship into something more like a partnership.

The internalization process is useful in that it gives the management more power and instruments to monitor and improve performance. On the other hand, the entrenched market may hinder new business from entering the market, making the vertical merger very anticompetitive.

The vertical integration following a merger in fact does not really change the number of players operating at one level of the market but acts as a mean of change of the general industrial behavior.

Whether a forward or backward integration, the newly acquired firm may decide to deal only with the acquiring firm, thereby altering competition among the acquiring firm's suppliers, customers, or competitors.

In terms of market efficiency, the downturn of a vertical merger is represented by phenomena like outlets deprived of supplies, competitors not able to access both supplies and outlets, etc.

Therefore, there is an issue of vertical integration as a means of market distortion, by foreclosing competitors through limited access to resources of market players. Vertical mergers may also be anticompetitive because their entrenched market power may impede new businesses from entering the market.

In the case of a conglomerate merger, the integration happens between two companies that operate in different business activities. Conglomerate transactions take many forms, ranging from short-term joint ventures to complete mergers.

A conglomerate merger involves companies that operate in different markets and can be pure and geographical or resemble a product line extension. There is no direct effect on competition for this type of merger.

Such a type of integration enhances supply to market and also the demand for new firms, thus inducing entrepreneurs to start new business. It also provides opportunity for firms to reduce capital cost and overhead and achieve other efficiencies.

On the other hand, a conglomerate merger may lead to a reduction of small companies in the market, while increasing the overall political power of the merged ones. In this way the democratic processes and independency of decisions are put at high risk.

In a reverse merger a company, usually a healthy one, is engaged in merging with another company that is financially weak, so that a new company comes to existence and the former is dissolved.

14.1.3 Hostile Takeovers and Defense Strategies

As mentioned before, when the acquisition is opposed by the management of the target company, it is defined as a hostile takeover. The management in this case advises its shareholders not to sell to the acquiring firm (Savela 1999).

The term hostile takeover also applies in the case when a bid is placed for the shares of the target company, and the management of it is not informed, so to be directly aimed to the shareholders (Damodaran 1997).

The purchasing offer can be in fact directly addressed to the shareholders, with or without having the management of the target firm giving the consent or going through negotiations.

The line is thin and the matter is controversial, because it happens sometimes that a takeover that starts as friendly and normal suddenly develops into a hostile bid, during the acquisition process.

Generally speaking, however, the terms hostile takeover identify that type of bids and offers which are generally aimed to the shareholders of a target company, in a way to get control over the company itself by overtaking the management.

There are several reasons behind the choice of making a hostile takeover, with the main one usually being the will to change the management. It is said in fact that the

best way of replacing an ineffective board or management of a targeted firm is through a hostile takeover.

There are cases in fact of companies that operate very inefficiently, besides having a great potential of business growth. As a consequence the shares of the company are undervalued on the market, while the real potential value is much greater.

The aim of the acquiring company is to then replace the board and management, so to let the company achieve its full potential and profitability, with the consequence of increasing the stock value.

It is obvious that companies having a bad management which pursues personal aims rather than the corporate objective are more subject to become the target of a hostile takeover through agreement with shareholders.

This type of behavior in some sense guarantees that all companies on the market are profitable in the long run. Short-run management inefficiencies in fact may be soon overtook by takeover and replacement.

As mentioned before, this could be due to the lack of economic growth potential the management has been able to realize or perhaps that the strategic plan of the board does not comply with the shareholders' view or expectations (Samuels et al. 1999).

It follows that the hostile takeover can in some cases be seen as a way to market effectiveness that helps achieving profitability and corporate value through simple management replacement (Weston et al. 2004).

There has been a lot of research done about the issue of positivity or negativity of takeovers. There is still no consensus about that, so still it seems that the beneficial or negative affects depend highly on whose angle one is viewing from.

Empirical research could not resolve the issue of the change in value of the acquiring and the target company. However, there is evidence that all the gains or positive effects tend to go to the shareholders of the target firm and that the acquiring firm pays a premium for their company.

Also, in most cases, the value of the target shares increases after a takeover, making it a profitable operation for its shareholders. In this sense, the term hostile is just limited to the reaction of the board and management to it. A takeover which takes the shareholders of the target firm in consideration first is called positive (Weston et al. 2004).

The bid on a takeover consists in an offer to be made to the shareholders of the target company. Such an offer is usually higher than the market values of the shares, in order to give incentive to a positive response.

The bid premium defines the difference between the offered price and the market price of the shares. It represents an extra on the market price, and its size depends on the willingness of the acquiring company to pay for the target company.

According to surveys done in the United Kingdom, average bid premiums of hostile takeovers in the United Kingdom are between 35 and 45% higher than the market price of the target company (Schoenberg 2003).

There are several possible reasons to develop a defense strategy against a hostile takeover. In one case the will is to prevent or block the takeover and prevent the

bidder from gaining ownership over the company's equities or stocks. In another case, the defense strategy is aimed at staggering the bid and even increasing it, thus resulting in a higher bid premium received by the target firm.

When the acquisition from another company goes through direct contact with the shareholders of the target company, the operation is considered hostile by the board of directors, which is not asked about it.

As from Savela (1999), there is a genesis for the expression of hostile takeover that resides in the negative attitude of boards. The reasons for such an attitude can perhaps be explained by several reasons and not always related to the valuation of the actual bid.

There are several reasons behind a negative attitude from the board of directors of a targeted company. They range from the fear of a negative effect on the company growth to the preoccupation with losing their positions and jobs (Bebchuk et al. 2002).

It is not surprising then that boards of targeted companies are ready to implement all possible actions in order to prevent a hostile takeover, preserving their independence and ensuring that the hostile bidder is pressured to sweeten their bid further.

It is clear to the directors that sometimes the defense is very unlikely to be successful. However, it can make the acquisition more costly or time-consuming for the acquiring company, thus making the targeted company less attractive due to the rise in cost which follows.

Also called shark repellent tactics or antitakeover measures, these measures can be used in a reactive approach to hinder a presented hostile bid or proactively to make sure that future raids from targeting companies are hindered (Pearce and Robinson 2004).

The range of possible strategies for defense is wide and it depends on the single case. The right reaction must be tailored to fit the acquisition strategy used by the acquirer, and the motives the targeted board of directors.

What follows is a review of some of the most common defense strategies and their use for defense against a hostile takeover. The main categorization is between proactive and reactive strategies, depending on when a company decides to adapt it.

Proactive measures are those used to make the company less attractive to potential acquirers. They are taken right before the actual hostile bid presents itself, and the later one is implemented in connection to the hostile bid (Pearce and Robinson 2004).

The first way a company has to take control over another company is to insert its own people in the board of the target company. Attaining representation and voting power are important to influence other board members to accept the bid or influence the shareholders to take a more positive stance toward the takeover (Bebchuk et al. 2002).

One tactic the targeted board can use for protection is through a staggered board, which can be created by first contacting the shareholders and letting them approve its creation in a meeting. It is then necessary to get seats on the board, again through a shareholder meeting where the members are chosen with the support of the shareholders.

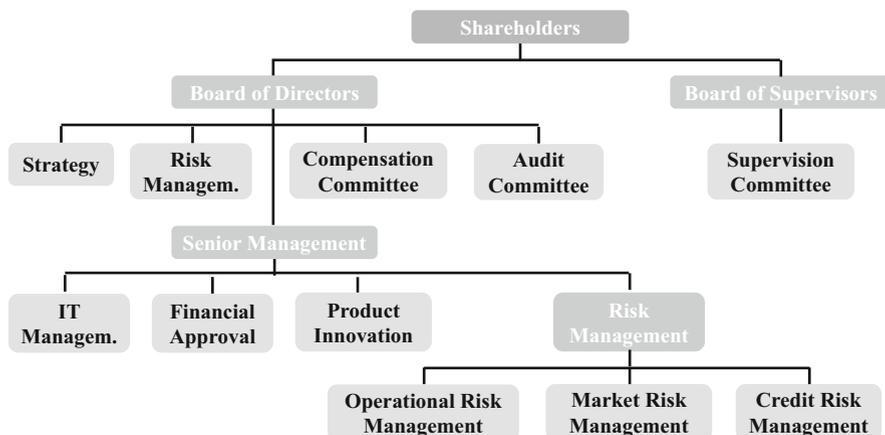


Fig. 14.1 An example of a typical board of a medium-big-sized bank

One way to infiltrate the board in this way is through the acquisition of enough shares to gain sufficient voting rights to elect one or more members to the board. The staggered board strategy is therefore a very time-consuming and expensive process of gaining influence and control on the board (see Fig. 14.1).

The practical method of running a staggered board strategy goes through several steps. First of all, a board is divided into groups. Replacing the board can take as many years as the number of groups created, not just one.

As a consequence, the acquiring company can start by acquiring a maximum number of seats equal to the number of the members in a single group and then wait for another year before having the chance to elect an additional amount of members. The process goes on until the acquiring company gains the majority of the board (Bebchuk et al. 2002).

The whole process clearly slows down a potential acquisition, making the staggered board a valid tactic against takeovers. It is an efficient method to prevent the acquirer from gaining control of the whole board instantly.

The large delay in gaining control, deriving from the defense application, results in increasing costs for the acquisition. Sometimes these extra expenditures make the target company less appealing, therefore discouraging the takeover (Bebchuk et al. 2002).

It was estimated that on average shareholders would get 8–10% less in acquisition premium from the bidder when adopting a staggered board. Though this tactic is moderately effective, it does not imply a definite protection against a hostile bid.

Obviously the staggered board strategy does not imply that the bidder cannot directly deal with shareholders by buying a large amount of shares, to gain control. In general, such a defense strategy is effective when combined with other defense measures.

Another popular defense strategy is the so-called poison pills and was introduced in 1982 with the name of warrant dividend plan. In its most common forms, it resembles the “flip-over” pill and the “flip-in” pill.

With a poison pill, the target company attempts to make its stock less attractive to the acquirer, by using different approaches. A “flip-in,” for example, allows existing shareholders (except the acquirer) to buy more shares at a discount.

The investors get extra profits by buying more shares cheaply, and, most important, they can dilute the shares held by the acquiring company. This makes the takeover attempt more difficult and more expensive.

Poison pill is one of the most used and controversial defense strategies used, which is derived from the domain of espionage. In particular, it relates to the practice of secret agents being captured who swallow a poisoned pill in order to die and not be interrogated.

Poison pills have many names and are therefore also described as, shareholders’ rights, preferred shares, stock warrants, or options, which the target company offers and issues to its shareholders (Pearce and Robinson 2004).

The board of directors is the only in power to redeem any poison pill once implemented. Rights become valid when they are triggered, not before (Ruback 1988). Triggering usually happens in the event of an unwanted takeover.

In case an unwanted shareholder acquires a pre-specified amount of the outstanding stocks which has been agreed on by the board of directors, it is still possible to stop the escalation by activating the poison pills.

There are usually pre-specified thresholds or ranges to be matched by an acquisition before implementing the defense. The range is usually set as 15–20% of the stock for a single shareholder who has not been in contact with the board of directors.

The threshold becomes higher in case a tender offer is put in place by the acquiring company. A tender offer is defined as targeting more than around the 30% of the targeted company (Pearce and Robinson 2004).

The implementation of a poison pill is such that it dilutes the capital of the targeted company. This action results in the bidder not being able to achieve control on an important part of the company without the consensus of the board, with a loss of time and money.

Another way to use poison pill is to create more time to analyze the actual bid and possibly enter negotiations with the acquirer. The process may lead the two companies to agree on some other terms.

Moreover, such a defense strategy is an efficient way to put pressure on the bidder to raise its premium offer even further thus serving the shareholders’ wealth (Bebchuk et al. 2002).

The preventive nature of a poison pill has been underlined by many researchers, like Theobald (2006), for example. In fact, he argues that the poison pill is a preventive measure even though it is implemented after a bid has been presented.

A flip-in pill, for example, allows the firm to issue preferred stocks that can be bought only by existing shareholders. When they decide to exercise their rights, they get the opportunity to buy additional shares in the company for a price below the market value of that share.

The acquiring company cannot participate in the exercise of those rights, therefore leaving its capital diluted, due to the impossibility to compete with shareholders who can buy them for a discounted price.

The benefit in time delaying is evident. The bidder's operation is slowed down, and the targeted company gets the time to reflect on the bidding situation and manage to give incentives to not sell to the uncertain shareholders (Pearce and Robinson 2004).

In a flip-over pill, the existing shareholders are offered rights rather than preferred stocks. These rights are only triggered and set in motion when the total amount of shares of the target company has been acquired by the bidder.

In particular, with a flip-over pill the shareholders of the targeted company acquire the right to buy the shares of the acquirer at a discounted price, in case a total merger or acquisition is put in place.

The main effect of exercising such rights is the negative impact on the balance sheet. In the event of exercise, in fact the direct consequence is an increase of debt for all the shareholders of the acquiring firm.

Increasing the debt means raising the risk of the company's financial leverage and is thus seen as very unattractive for the acquirer who has to inherit these debts. The disadvantage of such a strategy however is that it is only viable after 100% of the target company is acquired.

The important decisions in a company, including those about a merger or takeover approval, are usually taken with consent of the majority of the votes, represented by the voting rights attached to the shares.

However, it is possible to amend the corporate chart in order to dispose a supermajority for important decision-making. That means any important aspect including a potential takeover could be approved if a large shares of votes are obtained.

Such a defense measure can raise the specific quota needed to approve large majority decisions. The percentage needed for approval normally increases to somewhere between 67 and 90%.

The amendment to the companies' chart can only be implemented by the shareholders, and not by the board. However, it is the board that has the power to decide whether to activate it or not.

In this case, the bidder can complete the merger without actually owning the shares, but it only has to present a merger proposal which then the shareholders have to vote on but now have to acquire a larger acceptance (Ruback 1988).

The supermajority amendments are sometimes activated for all mergers, and sometimes only for the hostile takeovers, or when a large shareholder is involved in the operation.

These amendments are often accompanied by escape clauses which allow the board of directors to redeem the amendment if the board decides to change its attitude toward the bid and enter negotiations, thus not restraining the boards' managerial power.

This type of defense, like the others, is not very efficient if not combined with other strategies. As for the poison pills, it is an efficient method to stop the bidder

from immediately gaining control over the company and thus making the deal costly and unattractive. Moreover, the targeted company gains more time to reflect over the bid and perhaps negotiate with the bidder about a higher premium offer (Ruback 1988).

Another popular defense strategy is called golden parachute. It consists in a lump-sum payment to the board of the targeted company, meant at making the hostile takeover more costly and complicated.

The strategy is put in place after the takeover has started, and it usually starts at an acquisition percentage of 25%, with an average registered in the industry, of 26.6% according to public statistics.

Similar to other strategies, the golden parachute is usually implemented in combination with other tools, and on average, as from the findings of Lambert and Larcker, implementing golden parachutes as a line in defense measurements against hostile takeovers, on an average increased the wealth of the shareholders by 3%.

The golden parachute basically aligns the interests and incentives between shareholders and executives of the target company, in order to avoid agency problems, since generally managers are concerned about losing their job and may decide to oppose a hostile takeover, even when the latter has a positive impact on the value for the shareholders.

As it has been proven by Walking and Long in a study of 1984, the rationale behind golden parachute is that the probability of executives opposing a takeover bid is directly related to the takeover's effect on their personal wealth.

Also, it is argued that if receiving a large payment in the event of a job loss, the managers will be less inclined to block any takeover attempts and therefore evaluating the best decision for the shareholders (Harris 1990).

Summarizing, the golden parachute strategy makes more cumbersome and expensive any hostile takeover but only to a certain degree. Payments as a cause of the golden parachute strategy are a drop in the ocean compared to what the acquirement as a whole would cost. Therefore, it can be argued that the real effectiveness of the golden parachute strategy is limited.

Another class of possible defense strategies is the reactive defense measures. One way to implement it, for example, is to attack the logic of the bid, by trying to persuade the shareholders that a fusion will have a harmful outcome on both the company and the stock price.

As a strategy, it is quite effortless and cost-efficient, in case a hostile bid is placed. The board tries to convince the shareholders using arguments like the bid is too low or not adequate to the real value of the firm.

The board can also try to discourage their shareholders by accusing the acquiring company of being incompetent and only trying to acquire the firm's assets. However, such an action risks the result of shareholders thinking that the board is only interested in keeping their positions and not taking the shareholders' wealth into consideration (Weston et al. 2004).

Sometimes the board of the targeted company tends to share important information with other potential acquirers, in order to encourage them to compete in the bidding. This would of course create competition, resulting in a higher bid price

overall. Management could also raise doubts about the merger and encourage shareholders to hold their shares for additional bids (Turk 1992).

In the so-called white knight defense strategy, the board tries to involve a third-party friendly company (white knight) in the acquisition. The management of the targeted company can negotiate several deals that do not have to include a full takeover of the firm and risk losing their positions.

The boards can opt for a white knight because of friendly relationship and intentions, believing that the chosen company will be a better fit for the corporate strategies, and to make sure there will be no major changes in employment.

It can also be used to play the other two parties against each other to further sweeten the bid. The most common result of applying a white knight strategy is that the target firm eventually gets overtaken by the white knight.

The independency of the target company is therefore never guaranteed, and the strategy seems to be useful just in preventing a hostile bidder from implementing measures which would result in a greater restructuring of the firm.

The white squire is a variation of the white knight, based on a third-party company acquiring a minority stake of the target company. It is a smaller portion but enough to hinder the hostile bidder from acquiring a majority stake.

In case an investment fund is raised through financial advisors, this can be used to purchase a small portion of the target company, therefore not requiring the identification of an external company. Here, hedge funds and banks are suitable white squires due to their ability to move large amounts of capital on short notice (Weston 2001).

The greenmail strategy is targeted for those cases in which a bidder is more interested in short-term profitability rather than long-term corporate control. It involves the repurchase of a block of shares held by a single shareholder, offering a premium in exchange of the so-called standstill agreement.

Such an agreement states that the bidder will no longer be able to buy more shares for a period of time, often longer than 5 years. The hostile attack will then be over, and more important, such a covenant is proven effective toward short-termed profits seeking bidders, who are given incentives to keep the shares instead of selling.

The greenmail measure is still used because there are some bidders who act intentionally in such a way so to receive a greenmail offer from the targeted company (Pearce and Robinson 2004).

Another type of reactive defense named crown jewel allows the company to sell out its valuable assets when facing a hostile bid, in order to decrease its own value for the bidder and stop the takeover.

Another way of implementing this type of defense strategy is to combine it with the white knight, by selling its assets to another friendly company and later on, when and if the acquiring company withdraws its offer, buy back the assets (Weston 2001).

The risk in implementing the crown jewel strategy is to put the whole operation of the firm at high risk. Moreover, the sale of assets to a white knight should be accompanied by an agreement guaranteeing the possibility to purchase the assets back.

Another downside of the strategy is that the sale of assets in some cases may generate a high volume of incoming cash flows, making the target company even more appealing to the hostile bidder, with an opposite outcome of the strategy (Weston 2001).

The final and last resource is to act against a hostile bid through litigation, by pursuing legal injunction, filing antitrust litigations, restraining orders, or filing a lawsuit against the bidding company.

The aim is to put the bidder under the pressure of gathering information to prove the takeover is legitimate. The institutions handling these types of matters are usually accessed by the bidder in order to file all the documents proving it.

Besides being inefficient against long-term takeovers, the strategy allows the target company to gain space and time to implement further defense strategies in the time the bidder is preparing and presenting its legal preferences.

Another important function of litigation includes the propaganda made by the board against the bidder, so as to put the shareholder in doubt regarding the convenience of the bid.

Moreover, the strategy puts pressure on the bidding company, forcing it to publicly reveal the business plan and strategy to be adopted for the target company after the acquisition is eventually completed (Pearce and Robinson 2004).

14.2 Corporate Governance

Learning Outcomes

- Define and explain management failures.
- Understand remuneration and incentive systems.
- Learn about postcrisis perspectives.

14.2.1 Management Failures

A big role in financial crises has been played for sure by the failures in corporate finance, together with other factors. Many points of weakness are raised in the structure of companies that were considered very strong, making governance tools inadequate in the time the pressure started getting high.

The large lacks in governance skills caused many big financial institutions and large industrial corporations to suffer, and the focus of international initiatives and regulatory bodies was on how to elaborate an effective response to it.

At an international level, the standards for corporate governance are set by the Organization for Economic Cooperation and Development (OECD) and amended by other institutions like the BIS and the World Bank.

The OECD is represented for governance matters by the Corporate Governance Committee (CGC) which is responsible for the principles governing the field and for the development of innovations for the future.

The committee has done an extensive analysis of the state of art of governance before and during the years of crisis, coming to the conclusion that the most severe driving factor of governance failure was the wrong implementation of existing standards.

Moreover, it was clear from confrontation with other organizations that the need of new regulation was not so imminent, while focusing more on the application of existing rules appeared to be a more urgent task.

Based on the principles of regulation recommended by the central authorities, an action plan based on two pillars was developed by the committee. The first pillar relates to the implementation of basic principles in specific areas of actions, while the second one aims at developing dialogue and feedback in view of an effective monitoring and prompt identification of issues.

The range of areas involved in the new regulation includes governance of remuneration, effectiveness of risk management, and board and shareholders' rights and practices. The main lessons from the crisis have been convoluted into conclusions to be published by the organization.

The issue of remuneration has been considered of primary importance in the development of the crisis. In particular, incentive systems have failed in fostering efficiency, because they were not based on performance-related criteria.

In most cases the necessary link between compensation and performance was proven to be weak and difficult to observe. Moreover, compensation schemes were often complicated and obscure.

According to new principles, the remuneration packages should in fact be determined taking conflicts of interest into consideration and with the help of professional advisors. Moreover, the shareholders should also be involved in the approval of compensation schemes.

Long-term performance should be the basis for designing compensation schemes for the management, by linking some part of the remuneration to the corporate results, leaving it variable and adjusted to the related risks.

A natural consequence of the above consideration is the shift of compensation packages toward floating components, to be linked to performance, and with a limit in the fixed part. Transparency is a crucial point as well, in that information on remuneration should be available.

It also turned out that in most cases the boards were not aware of the riskiness of daily corporate life. Risk management practices were so far considered as marginal and were not integrated with the general corporate strategy.

All corporate strategies were centered on profitability, with risk management department left isolated and subordinated, so to make the disclosure of foreseeable risk very inefficient.

The CGC analyzed the situation issuing a main message from its work: the need of a major involvement of the corporate boards in establishing the risk management practices, with risk managers being independent from profit centers.

Many boards have been found not capable to objectively judge the risk profile of their corporation, therefore shifting the focus on the independence of board members rather than on competence and skills.

Phenomena like the interconnection between boards sharing the same members (interlocking directorate) and the tenure of some members have magnified the effect of conflicting interests.

The OECD principles are widely known as the leading force of corporate governance regulation. Supervisory and regulatory authorities should be properly equipped to face the weaknesses of corporate governance.

Several cases of bad governance have come to public knowledge at the beginning of the twenty-first century. Among those, the most famous is probably the Enron Corp. collapse. An American energy, commodities, and services company based in Houston, Texas, Enron was, at the time of collapse, one of the largest energy companies in the world.

In 2001 evidence of fraudulent practices, including institutionalized, systematic, and creative accounting fraud, was discovered, making the company an example of the worst type of corporate fraud and corruption even today.

Back to some years before, at the end of the century, the price of Enron's shares was high, due to the effect of the expectations generated by the fraudulent accounting figures communicated by the management to the public.

Ambitious industrial plans that seemed to be feasible in light of the financial statements were instead totally unreasonable given the true state of finances of the corporation.

The size of Enron was so big that the company turned into a sort of clearing house for the market of energy derivatives, claiming the ability to price them correctly, due to its combination of an underlying utility business with a market trading overlay.

The management of Enron at that time claimed to be pioneers of a new corporate model. Large income was generated by the company, with consequential high compensations paid to the top managers and high fees paid to third-party consultants.

But the rising share price was used to finance off-balance sheet transactions, aimed at inflating further the share price by overestimating the company's earnings. That strategy could not survive the general stock market fall which began in early 2000.

The price inflating strategy was then followed by other companies attracted by the above strategy. Apparently the failure of Enron did not work as a lesson for other companies.

The crash of the big American corporation had a huge impact on financial markets, with many hedge funds having invested large sums in the Enron stocks. The impact was limited for big investors with well-diversified portfolios, but it was huge for other investors and employees who suffered most of the burden, losing their jobs and also their retirement incomes.

The case of Enron was the spy of a global scenario of frauds and conflicts of interest perpetrated widely in the corporate sector. Without the fall of the big company, these would otherwise have been undiscovered.

Legislation in the United States needed to be renewed and updated and the authorities issued the Sarbanes-Oxley Act in 2002, in order to improve the

regulation, based on the conviction that the Enron case was in fact just an example of governance fraud.

The act introduced several innovations, for example, increasing the frequency of reporting due by corporations and by widening the range of obligations upon governance.

The main idea behind such a severe approach was that the board of directors of the companies should be chosen in light of independency, from external agents. However, there was no evidence, at that time, of a link between ineffective monitoring and the lack of independence of directors, either at Enron or elsewhere.

In the case of Europe, the most relevant example of corporate governance failure relates to the crack of the British bank and former building society, Northern Rock, in the United Kingdom, as a consequence of the financial crisis.

The British Companies Acts has served in the United Kingdom as the main form of regulation of corporate issues, for many years. After the world global crises of 1929, the regulation had to be changed in view of modern regulation of corporate governance.

The focus is again on interlocking directorate issues, leaving the floor to criticisms about the effectiveness of the Acts as a countermeasure against the issue of multiple boards of companies of the same group interacting with each other.

The Acts basically fails in requiring big groups to publish consolidated balance sheet and income account or an interlocking company to publish details of its holdings. This type of provision may serve as an incentive for transparency.

14.2.2 Remuneration and Incentive Systems

Management compensation and incentive structure have played a crucial role in the effectiveness of corporate governance, even in the years before the financial crisis fully exploded (see Fig. 14.2). The problem of remuneration was recognized at that time, as one of the unsolved problems in many countries.

The main focus is on the American economy, but of course the problem has never been confined to American companies, raising concerns also in Europe (Germany and Sweden in particular) and in the rest of the world, including (somehow surprisingly) China.

From the early 1990s on, the remuneration of managers, especially CEOs, has rapidly increased, making the difference with average workers' salary very big. This phenomenon happened proportionally to the increase in size of the corporations.

The increase in compensations however is not fully explained by the growth in the size of companies. A complementary issue that magnified the phenomenon is the practice of giving performance-related packages, which became very popular in the early 1990s due to salary caps introduced by the regulator.

In Europe, if one takes into consideration the period of years right before the crisis, normal salaries were growing at an average rate of 2%, while management compensations had a growth rate of about 14%. In the following years, the difference

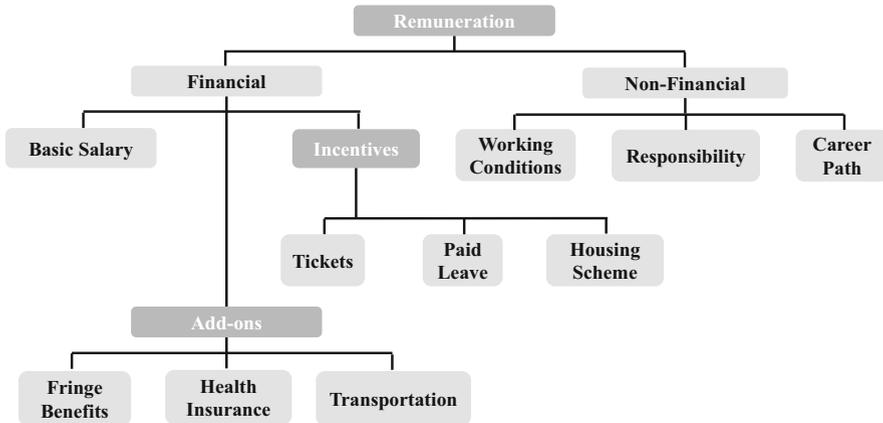


Fig. 14.2 An example of a typical remuneration package for top employees and managers

between the two classes of remuneration has grown more and more with a rapid increase of the ratio of CEO to average worker pay.

Basically a distressed situation was already in place, and the financial crisis contributed to make it even worse. It was in fact very common to reward top managers even in cases of failure or to assign them long lasting pensions and the continued use of company resources.

The presence of performance-related compensation was however insufficient to reach efficiency, given that the linkage criteria between compensation and performance were in practice very weak.

The compensation of top managers was more related to specific targets sometimes disconnected with executive performance, like the level of a company's share price, without any reference to the relative position of the company.

Executives were often compensated with shares of the company, therefore holding equity positions and sharing risk with the shareholders. As a result, the managers were facing a high risk.

However, as opposed to shareholders, managers could rely on the large compensation and bonuses attached to the performance, so to offset the losses on equity holdings and so to remove any incentive for the managers to limit the risk exposure of the corporation.

As a result, a very dangerous risk-taking behavior had spread among managers of major companies, leading to agency problems and highly risky situations. Only some of the managers, facing the pressure of public anger, gave up on their bonuses after their disasters were clearly observable.

A large number of corporations in the past years faced situations where structures of easy career advancement have led to excessive risk taking. As a consequence, dangerous behaviors have been put in place.

These behaviors include, but are not limited to, breaches of compliance obligations at all levels with serious consequences for the whole company, and it

was evident that strong incentives had to be complemented by adequate risk management systems.

Another issue faced by companies was the relative lack of consideration of the need for risk adjustments when measuring the performance-related criteria for compensation. Given that below the top management, employees were not remunerated with stocks; this became a major issue.

When risk adjustment is not taken into consideration, there is a conflict between the interest of the employees and that of the shareholders, so that the company is often faced with paying its employees much more than their contribution is, in the mid-long term.

Theories on the functioning of remuneration and management reward are controversial. A part of the literature states that reaching a decision on remuneration through bargaining necessarily leads to optimality and equilibrium, with the regulators left only to guarantee the transparency of the process.

Another point of view believes that managers normally benefit from asymmetric information, which gives them a high bargaining power. It follows that the contracts are never optimal for the corporation but biased by the asymmetry.

Information asymmetry and bargaining power are important issues, magnifying the effect of lack of guidance in developing trustable performance metrics and hindering the construction of an efficient remuneration system.

The OECD principles were revised in the years 2003–2004, strengthening them in terms of information disclosure and the consideration of the long-term interest of the corporation in light of business plan.

Due to the above principles, the board of directors is in charge of developing and disclosing clear and effective remuneration policies, including the compensation due to the board itself and the top management.

There should be a clear turn toward a long-term relationship between remuneration schemes and the interest of the company. Also, external advisors and nonexecutive board members should be put in charge of giving independent judgment about the financial integrity and potential conflicts of interest.

14.2.3 Postcrisis Perspectives

The future of corporate governance regulation is to be built on specific pillars. First of all, the new framework will have to address governance issues to respond to the future developments of financial markets in a prompt and efficient manner and include share ownership and shifts in investment strategy.

Many companies suffered for the menace of the failure of corporate governance, and the lack of core values, integrity, trust, and others has turned down the reputational level of the corporate sector in the world.

Proper and ethical behavior must arise as a resource, a valuable asset for the company, and a company with a reputation for ethical behavior in today's marketplace attracts both customer and employee loyalty.

The combination of good principles and ethical practices can lead to effective corporate governance. Fairness and honesty can be incorporated in the way companies conduct their affairs.

The legitimate goal of profitability must be bounded somehow by ethical consideration. Corporate image and reputation can be built on policies like environmental protection, ethical training, and compliance mechanisms.

Future corporate governance must face the challenge of the trade-off between the external regulatory provisions embedded in the system and the internal self-regulation, in order to balance the two.

The future of regulation goes through embracing all the aspects of modern corporate governance. Many experts around the world have observed there should be a new approach in terms of regulatory aspects, self-regulation, and the linkage to the market.

All the above considerations have an example in the Anglo-Saxon countries, usually characterized by well-balanced systems.

So the choice is between a self-regulation-based system, and a heavily regulated approach, and market based, where the latter could better serve the interests of the shareholders, in the opinion of the aforementioned scientists.

14.3 Risk Management

Learning Outcomes

- Define and explain the forms of corporate risk.
- Understand the risk management process.
- Elaborate response strategies.

14.3.1 Corporate Risk

A business in its daily life normally faces various types of risk, mostly identifiable in two broad categories, namely, business risk and financial risk. Contrary to what some people think, they are, in fact, not the same.

The difference between them is very important and must be known in order to appropriately handle both of them. The company profitability in fact is put at risk by both types of risk independently and simultaneously.

There is also an investor relationship perspective that is very important and relies on the understanding of the differences between risks. Financial investors, institutions, and other agents having interest in a company need to know the details.

As a broad category, business risk involves all the forms of risk related to business decisions, independently of the financial decisions. Examples of business risks are the risk to enter a new market, entering into a partnership with another business.

A rapid assessment of business risk is done internally. The efficiency and convenience of a project are assessed by experts in the company together with the calculation of the impact of such a project on the value of the company.

Business risk can be affected by several factors like the fluctuating demand for goods and services, changes in competition from other firms in the same industry, and introduction in the market of good alternatives to products and services. Other internal factors include the change of profitability ratios (gross margin, net margin, profit margin) as potential sources of business risk.

Other factors are disconnected from the actual business of the company and relate more to regulatory issues, with new intervention of authorities. Also, changes in the preference of customers can have a negative impact on the business.

Financial risk on the other hand relates to the capital structure of the company, with the focus on the corporate debt, which is the primary source of that type of risk. Companies with huge amounts of debt in fact are considered to be very risky, even if the assessment must also take into account the profitability generated by the investments financed by that debt.

As for business risk, there are several factors impacting on financial risk, including those relating to features and structure of the financial market which is domestic to the main activities of the corporation.

In case of a poor economy, the macroeconomic factors like undeveloped financial markets, high level of interest rates, and underrated currency may result in high risk, independently of the company structure and operations.

As a consequence, the leverage ratio of the company, given by the ratio of debt over equity, can be assumed as a good proxy for the corporate risk. Companies with high leverage usually entail higher levels of financial risks.

Whatever is the type of risk threatening the company, and whatever are the factors driving it, the risk management process is made of very precise steps, which can be summarized as:

- Identification.
- Measurement.
- Mitigation and/or transfer.

This section deals with general methods of risk management in general, and specifically for financial institutions, which are more involved in financial risk. In general, corporate stockholders are ready to accept that success for the business relies on taking appropriate risks (see Fig. 14.3).

As a general rule in finance, risk is such that any investor is compensated to bear it. For any level of risk, there is an adequate rate of return that compensates. So why should a company try to manage it?

The decision of hedging corporate financial risk comes from multiple perspectives. The main issue for a business is the riskiness of its debt. If the company defaults in facing its obligations, the consequence would involve direct and indirect costs that a firm should try to avoid.

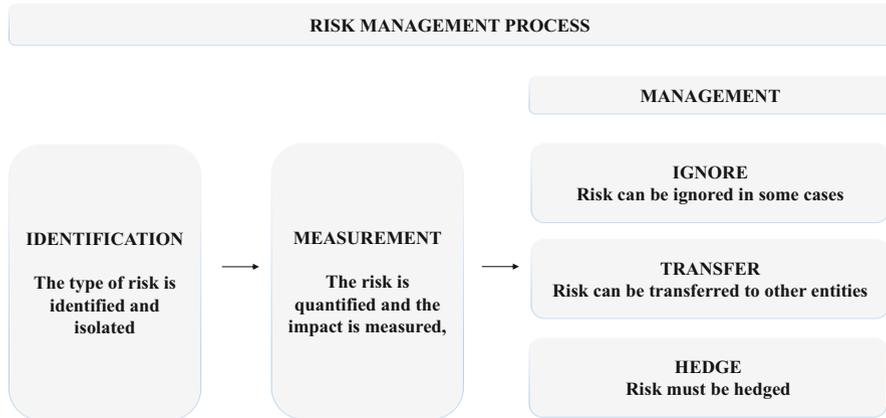


Fig. 14.3 An example of risk management process for a typical corporation

Direct costs of default are those that relate directly to the default of the company, when it happens. The category includes the costs for business reorganization through the bankruptcy process.

On the other hand, indirect costs involve all negative effects that the default can have as consequences. For example, there would be more difficulties in attracting new customers after facing a bankruptcy, as well as in entering new contracts.

In order to understand how costly such a process is, one should consider that often there are opportunity costs arising for a company, even if the default never occurs. The riskiness itself generates costs and that's why it is optimal to hedge risk most of the times.

Some managers may decide to engage in unethical behavior when facing a bankruptcy. It happens quite often that managers, on behalf of the shareholders, make inefficient decisions, just to drain most of the equity before the situation deteriorates.

Examples of inefficient and suboptimal decisions are underinvesting in profitable projects, even if they are useful to increase the value of the company, or maybe investing in negative NPV projects, thus carrying the risks only on the debt holders.

Findings of classical theory have suggested in past decades how to reduce the likelihood of default, through reduction of leverage. On the other hand, there is a tax shield effect which inevitably makes debt attractive to keep in the capital structure until some fair amount.

The tax shield effect is positive provided that the interest payments made on the debt are lower than the earnings associated with it. Generally, the benefits can be allocated in the balance sheet over the following years. Anyway in general the process involves loss of value, making it optimal to hedge risk in order to reduce the likelihood of losses.

Managers are risk averse due to the negative impact on their job that corporate distress may have. Their compensation is tied to the corporate profitability, and also if the company vanishes, they lose their positions.

This makes the interest of both the company and the managers converge toward hedging risk at all levels. The company will also pay less aggregate compensation to managers, due to the fact that risk-averse employees are willing to accept lower compensation if the whole employment package is less risky.

The impact on risk on the financials of the firm is evident as well. The value of corporate shares on the market strictly depends on the economy of the firm. When there is uncertainty about the ability of the firm to meet planned results, share prices tend to go down.

Investors in fact react to the news about the profitability of a company, and the uncertainty about the ability of the firm to meet its earnings and cash flow targets generates reactions on financial markets. The consequence is a high volatility of stock price, beyond market fluctuations.

This is why hedging risk is very important, in order to ensure some stability in the trend of stock prices, with a general positive effect of the new information hitting the market. This is also important in light of the different responses of investors to signals.

Another reason to ensure stability of revenues and cash inflows is that it is then possible to raise equity at a cheaper cost through profits retention. When a company needs capitals for new projects, the external sources are usually quite expensive.

Both corporations and financial institutions must undertake adequate process of their risk exposure, to maintain profitability and investor protection. The social implication of risk and distress is also important, especially for banks.

The following analysis is limited to banks, as an example of financial institutions that manage risk daily. There are several types of financial risk that are faced by a bank in its daily activities, with the main categories being:

- Credit risk.
- Market risk.
- Operational risk.

All banks must assess the three types of risk continuously in order to succeed. The profitability and social protection of liquidity are strongly dependent on the successful management of financial risk, at all levels.

Credit risk is the risk that a counterparty will not meet its financial obligation, leaving the bank with unpaid credits and missing liquidity. Losses on a portfolio, due to credit risk, can be divided into expected and unexpected losses.

Market risk refers to the loss of value due to market fluctuations, and operational risk is defined as the risk of losses due to failures in processes. They are easier to calculate than credit risk since there are more data available.

When all the above risk categories are assessed internally, the next step is aggregation. In order to manage risk properly, in fact, the combined effect of all risks must be taken into account.

On the other hand, the correlation among counterparties and among risks also plays a crucial role in order to assess the right amount of aggregate risk for each bank and optimize the risk management process.

The aggregation process involves the aggregation of the various risks and also the integration of the risks in the single departments of the bank. The management has then the chance to grasp the overall risk of a complex system and use the information to plan future activities and business.

The risk management process goes through several steps. From the identification of the risk to the management of it, good risk management must ensure that all investments undertaken add value to the corporation.

14.3.2 From Identification to Mitigation

The process of risk management is as important for a company as a good business plan. It is divided into steps, first one being the identification of the type of risk and its presence into an investment.

To analyze financial risk in the corporation, there are several methodologies. The most widely used is fundamental financial analysis. The tool is based on information about the firm, where the information mainly comes from the financial statement of the company.

The first look at risk comes from the proper observation of the income statement and cash flow statement. Using data from the financial statement in fact allows analysts to identify the assets at risk and the sources of riskiness to any specific risk factor.

The financial statement analysis is performed for internal use or external extended use, according to the purpose of the analysis. External use is done in the form of communications and reports to the stakeholders and the public.

The publicity of the corporate risk profile is important in that potential investors in a firm are always concerned about the riskiness of the business. For that reason, the major companies dedicate lots of resources to the issue.

The financial statement is composed of several books. The first one is the balance sheet, a report of the assets and liabilities of the company, together with the equity claims against the former.

Since the riskiness of the company is strictly related to the capital structure and leverage of the company, the balance sheet is a source of information about the capital structure of the company.

Starting from the balance sheet, the primary risk analysis is focused on the calculation of indices and ratios from asset and liabilities lined. The most important are:

- Debt on equity ratio shows the financial leverage of the firm. The higher the ratio, the higher the risk.
- Debt on asset ratio shows what part of the firm's capital is financed through debt.

- Return on asset (ROA) describes how much of capital is financed by the profits, therefore independently of debt sources and recapitalizations.
- Long-term debt on total debt describes the structure of company liabilities.

The information given by both long-term and short-term financial entries is very important when translated into ratios, because it generates risk awareness. All companies should manage to at least finance the fixed assets using fixed capital.

Doing that, the risk can be kept at reasonable levels, so that the company can benefit from appropriate management of resources.

Some companies operate internal risk management departments, but nowadays it is quite common for some companies to outsource the risk management tasks and engage outside consultants.

The expertise of external consultants allows for rapid risk identification, in the forms that are not evident to the insiders. An external eye is sometimes required to get a broader view of the company.

Time and resources involved in the risk management process are not small. There are some periods of corporate life in which the analysis of risk becomes very cumbersome for the management and employees. External consultants are therefore also useful in helping to assess risk with a consistent efficiency throughout the whole life of the firm.

As the first step in the risk management process, risk assessment involves the analysis of the likelihood and consequences of possible risk events and prioritizing those that must receive proper treatment. The criteria to evaluate the risk likelihood can be summarized in Table 14.1.

Once the likelihood of a risk event is established, it is time to assess the severity of the impact of such an event on the corporation. The strength of impact can thus be represented like in Table 14.2.

The information from the two tables can then be merged in order to get an aggregate representation of likelihood and impact of risk. This gives the complete information about riskiness in terms of the potential impact on the profitability of the firm. Such an outcome is usually represented in the risk priority Table 14.3.

When identification is done, the following step is the appropriate management of the risk. A good risk mitigation program can address the responsibility for the monitoring of the various risks.

Table 14.1 An example of how the likelihood of a risk event can be classified. Several levels of likelihood correspond to different probabilities for an event to happen

| Level | Likelihood of event |
|-------|--|
| 5 | Almost certain: The event will occur with a probability very close to 100% |
| 4 | Very likely: High probability that the event will occur in the short-medium term |
| 3 | Possible: Reasonable likelihood that the event will occur in the medium-long term |
| 2 | Unlikely: Low probability of an event, even in the medium-long term |
| 1 | Rare: The event will occur with a probability very close to 0% |

Table 14.2 An example of the impact a shock may have, given that the event has occurred

| Level | Impact |
|-------|---|
| 5 | Disaster: The desired outcome will not be achieved at all |
| 4 | Severe: The outcome is heavily affected by the shock, with big losses |
| 3 | Moderate: The business is partially affected, with moderate losses |
| 2 | Minor: The impact of the shock does not play a major role on the outcome |
| 1 | Negligible: The impact is so small that can be ignored |

Several levels of impact severity correspond to higher damages to the business

Table 14.3 The likelihood and impact scales can be combined to get a table of the different combinations of risk

| | Catastrophe | Major | Moderate | Severe | Disaster |
|----------------|-------------|---------|----------|--------|----------|
| Almost certain | Extreme | Extreme | Major | Major | Medium |
| Very likely | Extreme | Extreme | Major | Medium | Minor |
| Possible | Extreme | Major | Major | Medium | Minor |
| Unlikely | Major | Major | Medium | Minor | Minor |
| Rare | Medium | Medium | Minor | Minor | Minor |

A complete program includes the management and fixing of any potential material or virtual weakness in the corporate processes. The company board should implement recommendation from identification stage in order to reduce the risk exposure.

Effective signaling and vigilance of governance inappropriateness should be put in place and effective. Board members should give formality to decisions regarding risk management, with transparent reporting, in order to properly translate into clear and accessible reports of the firm's financial situation and exposure.

14.3.3 Response Strategies

After risk has been identified and measured, risk process terminates with the application of an appropriate response strategy to it. To do this, all risks must be first quantified and ranked in terms of impact and severity.

First of all, all risks are dealt with according to the risk tolerance of the agent. In this case the company must set its own level of risk tolerance and respond accordingly to it, so as to hedge the part of risk that is really unwanted.

When the level of risk is below tolerance, two possible reactions are avoidance and acceptance. In case tolerance is overtaken and an active strategy is needed, the two possible strategies are mitigation and transfer.

There are several factors to be considered when choosing the right response to implement. One example is the eventual dependence of the target task to other connected tasks, with riskiness being potentially transmittable. In this case, if severity is measured only on the first task, it could be underrated compared to the cumulative risk.

The first level of response is acceptance, which implies that risk [I inserted the word risk but I am not sure. You were saying that something is low but the word was missing] is so low that it is not worthwhile to do anything until the risk event occurs. The level of risk is therefore lower than the level of tolerance, and intervention is minimal.

It is in fact true that acceptance of risk does not mean absolute immobility. The event is not ignored, but no preventing action is put in place until the actual event occurs. Many insignificant risks fall into this category, and they are not the focus of our discussion.

Acceptance can have an active or a passive form. Active acceptance involves the tolerance of risk, accompanied by a detailed plan about actions to take in case the event occurs, as to be ready in advance.

On the other hand, passive acceptance is defined as the situation when no planning is made at all. In fact, the risk is so negligible that it cannot generate a real concern, and further actions are taken in real time when needed, and not planned before.

Transfer is another response method, involving the externalization of the responsibility for the risk or the risk itself. Risk can be transferred in several ways, for example, by rejecting parts of a project which are too risky.

It is also possible to act on prices to transfer risks, through demand of goods and services at a fixed price. Such a strategy implies that the contractor working on the project bears the risk of extra costs on the project realization.

The position of vendors is to set prices that are usually slightly higher than fair ones, and keep them fixed. The risk quote is therefore included in the prices, according to what a normal compensation for that type of risk would normally be.

Risk premium is a concept widely used in finance, which is useful to understand how proper compensation for risk is determined, on financial markets and business transactions.

The most popular way to transfer risk is however through an insurance, which involves payment of an affordable periodical premium in exchange of coverage against the target risk, which is transferred on the insurance company. The premium amount is a significantly small cost of the risk itself and the insurance pays if the risk event happens.

Risk avoidance is an extreme form of response to risk. It consists in implementing actions to fully and completely eliminate every possibility of an adverse event. Risk can be eliminated at the beginning, from any project, or dealt with after.

The obvious consequence of an avoidance approach is that all possibilities of an extra revenue as compensation of it are lost. It is therefore not so obvious to implement as a straightforward strategy.

A proper assessment is required before deciding to give up on all possible risk and, consequently, on potential extra compensation. In project design, risk can be sometimes avoided just by designing the project around it.

A much less extreme and therefore more popular form of risk response is mitigation, consisting in reducing unacceptable risk below tolerance level. Such a result is usually obtained through a proper reduction of the probability of the event to

happen. This reduces the expected loss associated to the risk and therefore requires less capital to be put on it.

The general way of implementing the strategy is to invest a little amount of extra money in the project in order to reduce its risk profile and avoid potential future large losses and extra expenses.

All of the above strategies come at a cost, including avoidance, where no money is allocated for risk, but expenses are required in order to redesign the investment. Acceptance is also costly in that money must be allocated for contingencies, even if no initial cost is incurred.

Risk mitigation involves setting up a budget in order to face a risk event but also requires some initial amount of money in order to finance the mitigation activities. Risk transfer requires a small amount of money to be given to the insurance or to the subcontractor.

14.4 Summary

Mergers and acquisitions are important operations put in place when two companies find out that combining effort may reduce the costs by increasing the economies of scale and therefore proceed with merging.

There are costs and benefits associated to acquiring a new firm, and firms choose their strategy based on both economic considerations and legal aspects related to the environment of operation of both firms.

Corporate governance is an important aspect of the firm's management and involves the highest levels of managerial force, impacting on the operations and financial decisions of the firm.

The election of the board of directors with the subsequent election of the CEO, CFO, and other top managers is the key to success. A specific aspect is the remuneration policy, with a focus on the aspects related to the shift from contracts with high fixed compensation to contracts heavily based on performance.

Risk management is about reducing and managing the risk associated with daily operations of the firm and protecting the corporate financials from the effects of external or internal shocks.

Modern risk management is based on well-planned processes that go from the identification of the source of risk, to the assessment of the danger associated to the risk and the management of it.

Credit risk, market risk, and operational risk are the three major types of risk faced by institutions, and the management of such risks involves the development of appropriate response strategies.

Problems

1. What are the main reasons for a merger?
2. What are the forms of speculative rationale?

3. Explain the role of diversification in the firm's economy.
4. Describe how a hostile takeover takes place, and explain the difference between positive and negative takeover.
5. Describe the main types of poison pills, as a tool to prevent takeovers.
6. The issues of concern to those who have worked to develop new explicit mechanisms for the external governance framework include:
 - (a) Company probity.
 - (b) Executive honesty.
 - (c) High audit fees.
 - (d) Political influence.
 - (e) The politics of profit and executive compensation.
7. Other issues that have not been addressed explicitly by corporate governance reformers yet which are viewed as important by society include:
 - (a) Corporate performance.
 - (b) Social responsibility.
 - (c) Ethics.
 - (d) Environmental standards.
 - (e) Health and safety.
8. Distinguish between internal and external corporate governance, and explain how they relate.
9. Explain the interdependence between economic development and corporate governance.
10. Describe the foundation of the present system of corporate governance as it applies to limited liability companies and how it developed.
11. What are the forces that shape corporate governance reform efforts and what triggers them?
12. When managing risk you will only be expected to counter risks which your business may reasonably be expected to face while providing its services. However risk management involves a process of steps to be taken in order. This order is:
 - (a) Risk identification, risk analysis, risk treatment, risk monitoring and review.
 - (b) Risk identification, risk treatment, risk analysis, risk monitoring and review.
 - (c) Risk analysis, risk identification, risk treatment, risk monitoring and review.
 - (d) Risk identification, risk analysis, risk monitoring and review, risk treatment.
13. What are the factors impacting on business risk?
14. List and explain the various forms of response to risk.
15. Explain in what context it is better for a firm to externalize the risk management function.

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