Cash and Stock Deals

When acquiring a company, the buyer may offer cash or its own shares or a combination of both as consideration to the selling shareholders.

Cash deals are usually quick and close fast as they face fewer hurdles to get done. And, with the acquirer in essence controlling the deal, determining who is in charge and how the companies will merge, they benefit from their simplicity. – On the other hand, raising the cash required to finance a deal may prove prohibitively expensive, time consuming, perhaps impossible in adverse market conditions. Besides, even if sufficient liquidity were avail, a cash transaction could deplete an acquirer´s reserves or diminish future cash flow generation, ultimately impeding further strategic steps. – As a matter of fact, offering cash places all transaction-related risks and rewards with the acquirer, in particular the risk that anticipated synergies may not materialize. This is crucial, as anticipated synergies drive a key component of the price of an acquisition: The control premium. - At the same time, though, a cash deal sends a strong signal to the markets that an acquirer has confidence in the rationale and value of a deal as well as that in its own stock.

In a stock deal (also: paper deal) the shareholders of the target company are paid in shares of the acquiring company. This structure may be considered if the buyer wants to keep its cash reserves, does not have sufficient funds avail or can´t access them. Having said that, a stock deal may actually be the preferred choice if target company shareholders want to participate in the future growth and upside potential of the new, combined business: Both, transaction-related as well as future operational and strategic risks (e.g. whether synergies can be successfully implemented or not) are shared between buying and selling shareholders. However, in a stock deal selling shareholders convert from owners exercising control over their business to a (usually) minority in a new, combined entity: Decisions affecting the value of the business are now by and large in the hands of the acquirer.

Stock deals can be structured with either a fixed or a floating exchange ratio (mindful that share prices of the acquirer as well as that of the target can change between signing and closing). – In a deal with a fixed exchange ratio the required number of shares to be issued by the acquirer is fixed: Therefore, the ownership structure as well as earnings accretion or dilution is known. In most cases, sellers tend to prefer deals with a floating exchange ratio, as the deal value is fixed and defined. Hence, the seller knows exactly how much it will get, no matter what happens to the share price of either the acquirer or that of the target.

To mitigate pre-closing risks in deals with a fixed exchange ratio, offers combined with a collar can – among others - protect target company shareholders from a drop in the bidder´s share price while at the same protecting an acquirer from excessive dilution, at least within a pre-defined corridor. - Post-closing instruments such as earnouts and contingent value rights can be used to manage the risk of a potential overpayment due to (unexpected, later) underperformance of the target.

The agreed upon - fixed or floating - exchange ratio determines the number of shares the acquirer must issue for each share of the target firm. At times, the valuation of such structures can be complex, though. This is due to some of the value of the merged firm (i.e. its anticipated synergies) is in essence handed over to the target firm: Hence – from the perspective of a selling shareholder -, valuing an offer (just) on the basis of an acquirer´s current share price is in most cases not correct: Instead, one may expect that the merged entity post-transaction will likely be a very different firm from that of its pre-merger stand-alone state. As a matter of fact, selling shareholders will therefore hold shares in a new, combined entity which will hopefully generating synergies, too.

RISK DISTRIBUTION

		PRE-CLOSING (MARKET) RISK	POST-CLOSING (OPERATING) RISK
ALL-CASH DEAL	ACQUIRER	ALL	ALL
	SELLER	NONE	NONE
FIXED-SHARE DEAL	ACQUIRER SELLER	EXPECTED PERCENTAGE OF OWNERSHIP	ACTUAL PERCENTAGE OF OWNERSHIP
FIXED-VALUE DEAL	ACQUIRER	ALL	ACTUAL PERCENTAGE OF OWNERSHIP
	SELLER	NONE	

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