BHPB bid for Rio - Shareholders get rich in failed bid

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The Australian has carried out a detailed analysis why the failed bid has made shareholders rich.

It may be pointed out that on November 12th 2007, BHP disclosed details of an all share merger offer for three BHP shares for each Rio share that it wished to pursue. Rio had refused to engage following BHP's private November 1st 2007 approach. As often happens, information leaks and speculation had influenced share prices between these dates. The market's overall reaction to this news is best indicated by comparing November 12th 2007 and October 31st 2007 close prices.

Rio was up by 31.8% while BHP was down by 6.2%. Investors were assigning a USD 29 billion positive expected value to the merger a substantial 7.2% increment to the companies' combined October 31st 2007 market capitalization. However, they expected BHP to have to pay Rio a USD 44 billion deal premium leaving BHP's shareholders USD 15 billion worse off.

Investors were betting that the initial terms would be sweetened. On November 12th 2007 close, Rio's share price was 3.35 times BHP's. On February 6th 2008 BHP launched a sweetened 3.4 to 1 all share hostile offer and promised a USD 30 billion post merger share buyback. Rio closed 30.5% up on its October 31st 2008 close. BHP was down 10.5%.

While the sweetened offer was expected, Rio's board immediately recommended against it raising market estimates of deal costs and time frames and cutting estimated deal completion probabilities.

Expected merger value creation was now only USD 17 billion. Most of the USD 12 billion value lost was borne by BHP shareholders. There were other reasons why investors didn't like the February 2008 bid. Rio had snookered BHP by not engaging and requesting the UK takeovers panel to set a deadline by which BHP had to either make a hostile bid or abandon any intentions.

As the February 6th 2008 deadline represented BHP's last chance, its incentive was to bid high. And Rio's non engagement raised BHP's risk, as it could only do outside in analysis. While markets' initial reactions to deal announcements aren't always right, substantial evidence shows that they correctly predict whether deals will create or destroy long term value in at least 75%of cases. On average, the market initially predicts M&A deals will create 2% to 4% value. But for the average all share deals, it predicts 0 to 3%value destruction. So the market initially predicted a BHP Rio merger would create much more value than a typical all share deal.

But evidence also shows that on average, the target's shareholders capture all the value created. The market actually marks down the shares of a typical all share bidder by 1 to 2%. About 70% of all share bidders overpay. The average deal premium is about 25%. At a 3.4:1 share exchange, the BHP Rio merger premium was 45%.

Therefore, even on February 2008 well before conditions changed, investors thought BHP shareholders would lose. Tracking share price movements can give board invaluable insights into whether and why investors think your moves will create or destroy value. It serves to warn when you need to try to change their perceptions or if you can't, enable you to can the deal and cut your losses early.

BHP was right, as changed conditions made the deal look worse. Mr Don Argus chairman of BHPB explained that estimates of a merged BHP Rio's market capitalization and net debt had fallen from USD 298 billion and USD 87 billion, respectively, in February 2008 to USD 84 billion and USD 78 billion, respectively. Estimated market gearing had therefore jumped from 22.6% to 48.1%.

While buyback commitments elicit merger support, they can be couched in ways to generate the same support but with less risk to the deal if conditions change.

Rather than fixing a dollar commitment, BHP could have committed to a 9.1% buyback which at February 2008 prices would have been worth USD 30 billion. But if share prices fell so too would the cash cost of this commitment. Indeed, a 9.1% buyback would now cost only USD 10.4 billion. They would enable BHP Rio to cut debt another USD 19.6 billion and gearing to a more acceptable 36.1%.

Relinquishing the deal boosted BHP's price for other reasons too. While it would be nice to change deal terms as conditions change, this is outlawed for important market conduct reasons. But dumping the deal created options and raises their value.

The resulting Rio share price freefall may trigger board changes sounding a warning to future targets against recalcitrance.

It may also force Rio to divest assets at fire sale prices, which BHP may snap up. And BHP may revisit a Rio deal on more attractive terms later.

It also sends a valuable signal to other players. Rio's plummeting price imposed multi billion dollar losses on rivals like Chinalco and Alcoa, which took stakes in Rio to block the merger. They might think twice next time. And it signals to BHP shareholders that their management is disciplined. M&A failure rates increase with the relative size of the target. Rio was a bet the company move for BHP. While BHP claims that the merger synergies are otherwise unavailable, they're mainly concentrated in one or two businesses iron ore, coal.

(Sourced from The Australian)

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