Economics of Organizations
Pablo Ruiz Verdú
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Read the following excerpts from the articles "A $45 billion bet," "The Microhoo! hoo-hah," and "Just say no" from the Feb 1st 2008, Feb 5th 2008, and Feb 14th 2008 editions, respectively, of *The Economist.* Next Wednesday we will discuss the following questions:

1. How would you apply the Value Maximization Principle (VMP) to evaluate whether the acquisition is efficient?

2. Can we conclude from the Efficiency Principle that the acquisition will take place if it is efficient?

3. Should regulatory authorities intervene in any way in the merger?

A $45 billion bet
Microsoft's bid for Yahoo!

"It is a potential deal that has been talked about for years, but has suddenly become a real possibility. On Friday February 1st Microsoft, the world's biggest software company, made a $44.6 billion offer for Yahoo!, an ailing internet giant. The proposed deal, which would transform the software and internet-services industries, values Yahoo! at $31 a share, a 62% premium over the closing price on Thursday.

In a letter to the board of Yahoo!, Microsoft's chief executive, Steve Ballmer, referred to previous discussions between the two companies in 2006 and 2007 about a possible partnership or merger. At the time, Yahoo! was hopeful that Panama, a new system it had developed to place advertisements next to the results of internet searches, would improve its fortunes and help it to catch up with Google, the leader in both internet search and advertising. Panama failed to live up to expectations, however, prompting Yahoo!'s chief executive, Terry Semel, to resign in June 2007.

His place was taken by Jerry Yang, one of Yahoo!'s co-founders, who promised to put things right at the sprawling internet conglomerate. But Yahoo!'s latest results, released on January 30th, were disappointing, and its share price fell to a four-year low. […]

Google is not mentioned anywhere in Mr. Ballmer's letter, but its increasing clout in the online-advertising market, as a result of its leadership in search, is what has motivated the deal. […] Combining Yahoo!, the number two in search and advertising, with Microsoft, the number three, would provide a stronger competitor in an industry where scale provides a huge advantage. […] Microsoft is desperate to grab a bigger share of the online-advertising market because many of its software products are being challenged by free, advertising-supported services offered by Google. […]

Whatever Yahoo!'s management makes of the offer, the firm's shareholders will be delighted at the news. Microsoft shareholders are likely to be less enthusiastic: integrating the two companies would be a mammoth task, and Microsoft has never made an acquisition on anything approaching this scale before. Some sceptics say that this is too much to pay for a troubled company, even if it is, by some measures, the world's biggest internet firm. Microsoft says it is confident that regulators will approve the deal, which could be completed by the end of the year."

The Microhoo! hoo-hah
Microsoft's controversial bid for Yahoo!

" […] Any Yahoo! board member with a minute to spare should go to YouTube and watch Mr Ballmer, hooting and romping like a deranged gorilla, yowl "I love this company!" and then agree at once to accept his $44.5 billion offer for their firm. For there is only going to be one winner in this fight. […]

By offering a premium of over 60% on Yahoo!'s share price, Mr Ballmer has taken his lead from Rupert Murdoch's triumphant acquisition of Dow Jones last year—and Microsoft does not even have a divided founding family with split loyalties to win round. Institutional investors own 71% of the shares in Yahoo! By offering so much, Microsoft is likely to scare off any potential rivals, including Mr. Murdoch. […]

The so-called "bear hug" letter that Mr. Ballmer sent to Yahoo!'s board on January 31st is a masterpiece, showing how far a bidder can go nowadays without formally declaring itself hostile. Given today's super-accountable corporate governance, the board has to take the offer seriously, and may be hard-pressed to turn it down without provoking fury—and probably litigation—from its shareholders. […]

Mr. Ballmer deftly generates internal pressure for the deal from Yahoo!'s employees—an army that has suffered losses during the company's recent struggles—by promising "to offer significant retention packages to your engineers, key leaders and employees across all disciplines."

None of which is to deny that Microsoft is probably offering too much money in what seems an act of desperation. The phrase "culture clash" leaps to mind: Microsoft would have its work cut out fusing the two firms into a genuine competitor to the runaway market leader, which Mr. Ballmer refers to only as "one player" but the rest of us call Google. On the other hand, Microsoft and Yahoo! can hardly challenge Google together less effectively than they have been doing apart.

Perhaps the biggest obstacle to the creation of Microhoo! is the antitrust authorities, which have been on Microsoft's case for a decade already. Microsoft can plausibly argue that buying Yahoo! would increase competition in the market for search engines and online advertising by providing a genuine alternative to Google. Some argue that Microsoft is trying to extend its desktop monopoly into search engines (as it did with web browsers), but this seems implausible: the search-engine market surely has more monopoly power nowadays than the desktop market. […]"

Just say no
When and how, exactly, can a company decline to be bought?

“On February 11th Yahoo!, a pioneering internet company, turned down a takeover offer worth $44.6 billion from Microsoft. The software giant had made the bid public a week earlier in a “bear hug” letter designed to press Yahoo! into accepting. But Microsoft's bid, even at a 62% premium to the market price of Yahoo! shares at the time, “substantially undervalues” the company, Yahoo!'s board contended. […]

Microsoft's letter to the board of Yahoo! does not constitute a formal offer, or oblige it to make one. That said, going public with a letter in the way Microsoft has done is not without risk, as it may alert other potential buyers. But Microsoft appears to have concluded that publicising the premium it is willing to pay for Yahoo! is more likely to scare off other bidders.

Yahoo! has several options, depending on how determined it is to maintain its independence. Two decades ago the courts in Delaware ruled that a board could “just say no” to an offer it did not like, for whatever reason and however much shareholders disagreed, and that would be the end of the matter. But a series of court cases, and the growing power and activism of America's institutional shareholders, have reduced the board's freedom of action since those heady days.

In today's litigious climate, Yahoo! must at least go through the motions of demonstrating that its decision to reject the bid is being done in the best interests of its shareholders, which means plenty of work for its investment bankers as they explain why the firm's low share price is an aberration, and why Microsoft's (non-binding) offer is not as generous as it looks.

Yahoo! has also been considering a defensive tie-up with Google, AOL or News Corp to keep Microsoft at bay. Failing that, it could encourage the antitrust authorities to intervene, as PeopleSoft did in 2003 when a rival software firm, Oracle, launched a hostile bid. Microsoft has been the target of the trustbusters before, after all. But it is a high-risk strategy, for if the buyer then makes a new offer that the board wants to accept, the antitrust authorities may not go away.

Yahoo! might also try another of PeopleSoft's tactics: using a “poison pill” scheme to issue new shares and make a takeover impossibly expensive […].[1] The legality of doing this when most shareholders want to accept a bid is not as clear as it was: an attempt to have PeopleSoft's poison pill thrown out might have had a good chance of success, but the case was not decided in court because PeopleSoft bowed to its shareholders and accepted Oracle's bid.

Most lawyers think that, one way or another, Yahoo!'s board will have to accede to the wishes of its shareholders, many of whom seem to be keener on squeezing a slightly higher offer out of Microsoft than scaring it away. In a letter on February 10th Bill Miller of Legg Mason, the second-largest shareholder in Yahoo!, said that his valuation of Yahoo! was in the region of $40 a share (compared with the $31 now on offer) and that he expects Microsoft to “do what it takes”. In short, by saying no, Yahoo! […] is probably just playing hard to get.”

[1] A “poison pill” is basically a procedure to make it more costly for the acquirer to acquire the target. How exactly poison pills work is not that important for our purposes.