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ANALYSIS OF RECENT HOSTILE TAKEOVER BID: ALTERNATIVE VALUATION AND POISON PILLS IMPLEMENTATION

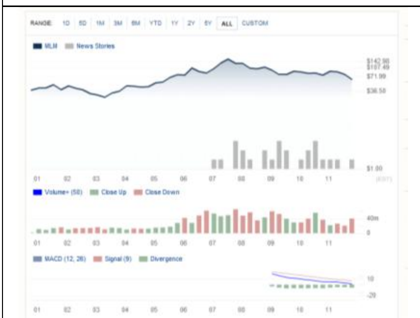
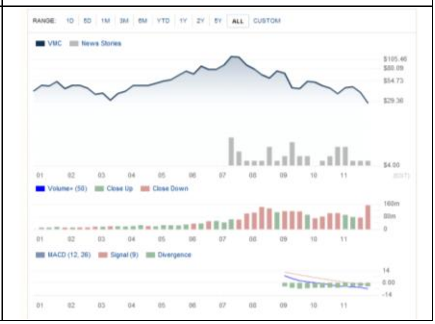
This analysis investigates the recent M&A bid in US road-construction materials industry from position of potential hostile takeover. The goal is to find and analyze the rationale and reasoning from the position of the target's shareholders and propose possible defenses to the bid, identifying the material risks that each of these defenses present.

On Monday, 12 December 2011, Martin Marietta Materials — a North Carolina based corporation — announced a $4.7 billion takeover of Vulcan. The bidder indicated that it would nominate its own slate of directors to Vulcan's board in 2012. Vulcan Materials Co. is a New Jersey corporation headquartered in Birmingham, Alabama. It is the largest US producer of road-construction materials. Vulcan's stock is owned mostly by institutional investors.

The proposed offer values Vulcan at about $4.7 billion or $36.69 per share, representing a premium of 9.4 % to Vulcan's closing price on Friday, December 16, 2010. The offer is based on a valuation that gives 9.4 % premium to Vulcan's recent closing price. Such an approach demonstrates the logic of efficient markets, when the price at any point of time represents the true value of the underlying asset. The premium in the case is simply a motivator that encourages shareholders to accept the deal shortly. However, it is arguable to apply such a methodology in the current situation of world economy and finance distress, when the majority of the companies are potentially undervalued or exist in the downturn industry situation. One more interesting fact to consider is the reaction of Martin Marietta on instantaneous Vulcan's rejection, when the acquirer friendly proposed to discuss the additional premium to the first offer ($38.20 per share), which might demonstrate intentionally underestimated initial price to prolong the negotiation process. In the discussion below, a few methods of alternative valuation are to be assessed to identify the fair price.

Acting as a hypothetical advisor for Vulcan, I would propose on the Discounted Cash Flow (DCF) valuation as an adequate choice in the current economic settings. Also I would propose to take into consideration industry business cycles. On the figure 1, the stock history of the Martin Marietta Materials and Vulcan Materials clearly demonstrates 3-4 year industry cycles (which started to decline in 2001, had bottom point in 2003, grew from 2003 until the middle of 2007, and started to fall from 2007 until now). Following the industry cycles, it is possible that building materials sector is to resume the growth in the nearest future; however, taking into account the exhibitions of crisis development in different countries all over the world, I can assume that the current cycle can continue for an uncertain short-term period of time (0.5-1 years) until the evident signs of global economy recovery.

Figure 1: 2001-2011 stock history of the Martin Marietta Materials and Vulcan Materials

Martin Marietta Materials	*Vulcan Materials*
	

DCF valuation of Vulcan enables to project the free cash flows to firm/equity based on the industry business cycle and termination growth rate of the company. The data for analysis and the source of information is presented in the table 1 below.

Table 1: The initial data for DCF valuation

Long-term interest bearing debt (million $)	2,718	Annual report 2010
Long term debt interest rate	7.02 %	Annual report 2010
Beta of Vulcan	1.29	http://pages.stern.nyu.edu/~adamodar/New_Home_Page/data.html
Equity Risk Premium (December 1, 2011)	6.51 %	http://pages.stern.nyu.edu/~adamodar/
Risk free rate (10 year Treasury bonds)	1.97 %	http://www.federalreserve.gov/releases/h15/update/
Shareholders' Equity (million $)	3,965	Annual report 2010
Debt (% of total capital)	40.7 %	Annual report 2010
Effective tax rate	46.6 %	Annual report 2010
Cost of debt	3.75 %	Author's calculations
Cost of equity	7.83 %	Author's calculations
WACC	6.17 %	Author's calculations

The assumptions of non-changing capital structure, beta, and effective tax rate are taken into consideration. Comparing the total revenue record from 2000 until 2010 with the stock performance history, it can be noticed that the stock cycle is 1-year shifted from the revenue cycle, which is taken into account. I assume that 2012 is a determinative year after which the sector is to demonstrate the obvious recovery.

Table 2: DCF valuation

	2011	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**	**2018**	**2019**	**2020**
Revenue	2,610	2,741	2,905	3,108	3,357	3,693	3,840	3,917	3,917	3,839
EBIT	35	72	148	306	330	397	428	437	437	428
Net Earnings	-46	27	103	261	285	351	383	392	392	383
FCFF	59.5	63.6	77.7	103.7	138.8	192.2	217.9	231.7	231.7	217.6
Operating CF	206.0	227.1	255.2	292.2	340.8	412.4	446.0	464.1	464.1	445.7
Tax	91.5	96.1	101.8	109.0	117.7	129.4	134.6	137.3	137.3	134.6
Change NWC	5.0	15.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0	20.0
Investment	50.0	52.5	55.7	59.5	64.3	70.7	73.6	75.0	75.0	73.5
DFCF	206.0	213.9	226.4	244.2	268.3	305.7	311.5	305.2	287.5	260.1
Growth rate	-	5 %	6 %	7 %	8 %	10 %	4 %	2 %	0 %	-2 %

The growth rate is estimated based on the industry cycles. The terminal value of the company after 2020 ($4.1 billion) is calculated on the assumption of 2.5 % average annual growth. Total value of the company is $6.0 billion which gives the price per share of $46.39 based on the assumption of non-changing number of stocks outstanding (129 million shares).

Proposing other appropriate methods, it might be useful to take into consideration the behavioral finance approach. The 52-week low price of $26.19 per share (on October 3, 2011) and the current price of $39.57 per share (on December 23, 2011) demonstrate both the upward trend before December 11 and speculations after this date on the announcement of Martin Marietta offer. The 52-week high price ($46.91 per share on February 17, 2011) might be a benchmark indicator of the potential proposal. However, on the falling market the acquirers don't want to pay 52-week highs, the targets frequently use it in the estimation. If Martin Marietta relies much on the estimated synergy effect of the deal ($200-250 million annually) it would not be arguable issue to take into account this indicator.

Thus, based on the valuation provided, the potential proposal should be 26.4 % higher to reach the fair value of the stock. Acting as a hypothetical advisor for Vulcan, I would recommend the board to negotiate with the shareholders about rejecting the offer of Martin Marietta, persuading them about the fair price of $46.39 per share in the current economic settings.

Also, as the proposal of Martin Marietta is not canceled or terminated, it is necessary to consider both categories of defensive measures — those that can be deployed (1) at the acquisition process and (2) after acquisition has emerged (or a sound combination of the two). The potential problem with the ownership structure of Vulcan is that the stocks are owned mostly by institutional investors. The announcement of the offer directly to the shareholders of Vulcan restricts the number of defense measures that can be potentially implemented. If negotiations with the investors fail, the change of shares of Vulcan to those of Martin Marietta may be out of the board's control.

One of the defenses to deploy can be rapid improvement of operating efficiency. Vulcan's operating indicators are worse than those of Martin Marietta: gross profit margin (21.3 % against 24.8 %), SG&A of net sales (11.1 % against 8.4 %), EBIT margin (10.0 % against 16.8 %), net income margin (3.3 % against 9.0 %), return on equity (2.7 % against 13.1 %). As some investors may rely basically on current operating performance, the company should show the actions to improve the indicators and to demonstrate short-term progress. If the offer is not extended, the investors can wait until May 18, 2012 to exchange the shares. Thus, it is vitally important to announce the considerable cost-cuts initiatives to demonstrate the positive dynamics in the 1st Quarter of 2012.

Vulcan may also think about deploying a voting-rights plan, which separates certain shareholders from their full voting powers at a predetermined point. For instance, if through the announced offer Martin Marietta accumulates certain share of Vulcan, it can lobby the hostile policy towards the company. The plan can restrict Martin Marietta (or any other shareholder with hostile interests) in voting over potentially unfriendly issues, such as the acceptance or rejection of a takeover bid. This requirement can make it difficult for an acquirer to gain control of a company. However, it would be very difficult for management to convince shareholders that voting-right clauses benefit them (especially considering the fact that the declaration of such clauses is often followed by a drop in stock price which can stimulate other shareholders to exchange the shares).

Vulcan may deploy flip-in or flip-over poison pills to depress the takeover. Both pills seem discouraging for Martin Marietta as its likely influence on Vulcan will be decreased. The institutional investors may like the idea of buying more shares below market value if the Martin Marietta gains a certain percentage of the Vulcan's shares. And if Vulcan can accumulate some percentage of Martin Marietta shares, these pills can be used with the combination of «Pac Man» tactics to acquire the would-be acquirer. However, accumulating the shares may be dangerous for the deal as well, because Vulcan artificially increases the share price of Martin Marietta stimulating other shareholders to exchange more shares.

One more potential defense is a «staggered board», when the board is to be divided into different classes when only one class is elected each year, so it would take a few years for acquirer to control or turn over the board completely. This period of time of a few years is enough to spoil the situation for acquirer, which considerably increases the cost of the takeover. Also the removal of Directors is difficult and inconvenient and should require inappropriate actions of the Director.

Analyzing the potential partnerships in the industry for itself, Vulcan can estimate the synergy effect from collaboration with CEMEX, or smaller companies as Texas Industries, Eagle Materials, or others. If not being a «White knight» for Vulcan, the companies may create a maneuver for possible acquisition of the smaller peer. Such a merger can not only deter the raider, but can also benefit shareholders in the short term, if the terms are favorable, as well as in the long term if the merger is a good strategic fit. However, the process of finding the comfort partner for the deal might be long, costly and possibly unsuccessful.

Vulcan may also think about deploying of «golden parachutes» for the management team and «silver parachutes» for other key personnel in the company to discourage the hostile acquirer by providing lucrative compensation agreements. If exercised, bonus plans will significantly increases the cost of the acquisition.

The classical «Crown Jewel» defense might be useful for the consideration as well. If Vulcan can spin off some most valuable assets in the key regions, transfer them to another entity and distribute among the shareholders the stocks of this new company, it will hamper the plans of Martin Marietta to benefit from the possible synergy. Also the creation of such companies may give addition impact to the effectiveness in the regions of presence because of the geographical focus strategy and cost management.

Taking into account the long-lasting negotiations between the parties about the potential merger, it can be proved that Martin Marietta obtained from Vulcan highly sensitive, material, non-public and confidential information under certain agreements. The misuse and improper disclosure of critical confidential information in connection with its offer is a material breach of these agreements and a violation of federal securities laws. Martin Marietta not only illegally disclosed confidential information in breach of these agreements, it also failed to disclose that, in violation of federal securities laws, it is in possession of material, non-public proprietary information about Vulcan. Therefore, Vulcan has commenced litigation against Martin Marietta to enjoin the offer and enforce its rights under the agreements and the federal securities laws (Bloomberg 2011).

Moreover, Vulcan may try to suspend or cancel the offer using the antitrust uncertainty of the deal. Martin Marietta is proposing the combination of the two largest producers of construction aggregates in the country. Vulcan may try to prove the aggregated company restricts competition in some regions and brings some risk to the country's industry effectiveness (Barusch 2011).

I would highly recommend returning to practice of steady dividends as soon as possible. It is obvious that the decision of cutting them was not simple but affected by sales slump amid lower government spending on roads. The market always reacts negatively to such news, and the investors stay unconfident for some time even after returning to high and stable dividends later.

If the Martin Marietta bid does not succeed, doubtlessly Vulcan gets an impulse for the future development. The competitive environment showed a clear signal that the company is not in the best fit nowadays and can be attacked later. The stressed management is to bring significant changes starting immediately. Cost-cut plan is a sound decision; however, the effect might be still short-term. For the growth over the projected period of time, company is to come up with the new philosophy of the company, new idea of the existence, new style of management and new concept of operations. Also the company may look for a strategic alliance or merger with another player of construction materials industry in case it cannot develop the strategy itself or results of such a strategy will not be attractive for shareholders. Except for increasing operating business attractiveness, the company is advised to implement new measures against hostile takeover.

References

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