# Weighing a cash offer versus a stock offer

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In a stock deal, a portion or the entire amount of the acquisition price is paid in shares of the acquiring company. In a cash deal, the acquisition price is paid in cash.
In stock deals, buyers share both the value and the risks of the transaction with the shareholders of the company they acquire in proportion to the percentage of the combined company the acquiring and selling shareholders each will own. In cash transactions, acquiring shareholders take on the entire risk that the expected synergy value embedded in the acquisition premium will not materialize. Sellers can often achieve a higher price for their companies by accepting stock deals

The amount of cash transactions versus stock transactions fluctuates greatly over time:

- in 1988, nearly 60% of the value of large deals—those over $100 million—was paid for entirely in cash
- in 1998, only about 20% of transactions were paid for entirely in cash
- in the 2003-2006 M&A wave, cash deals were up sharply and represented about 50% of all transactions (excluding private equity deals)

A seller should consider the following aspects when weighing a stock deal versus a cash deal:

- tax implications
- strength/potential of acquiring company
- seller’s short term need for cash
- seller’s risk comfort level

Stock deals enjoy a distinct financial advantage over cash deals due to U.S. tax policy (stock for stock deals are not considered taxable events).

The following examples illustrate the potential impact of accepting cash versus stock:

*Example 1: Dairy Queen-Berkshire Hathaway Transaction*

Warren Buffet's company, Berkshire Hathaway, Inc. bought Dairy Queen in October of 1997. Berkshire's share price at the time was $47,500/share. Dairy Queen shareholders had the option to choose between $26/share in cash versus $27/share in Berkshire stock.
Berkshire Hathaway shares were at about $80,000/share in June 1998:

- In June 1998, the previous owner of 100,000 Dairy Queen shares who went for the cash deal would have been worth $2,600,000 (in cash)
- In June 1998, the previous owner of 100,000 Dairy Queen shares who went for the stock deal would have owned about 57 shares of Berkshire Hathaway worth $4,560,000
- A 75.4% difference in value after less than 12 month

*Example 2: AOL – Time Warner Transaction*

On January 11, 2001 AOL acquired Time Warner (at the time largest deal in history with a $164 billion value). On January 9, 2000, the day before the deal was announced, Time Warner's shares traded at $64.75. AOL shares traded at $73.76. Time Warner shareholders received 1.5 shares of AOL Time Warner stock for each share of Time Warner stock they owned. The dot com bubble burst shortly after the completion of the transaction which caused AOL Time Warner shares to drop significantly. The resulting goodwill write-off caused AOL Time Warner to report a loss of $99 billion in 2002 — at the time, the largest loss ever reported by a company.
On July 1, 2002, AOL Time Warner's share price traded at $14.40

- 100,000 Time Warner shares valued at $6,575,000 on January 9, 2000 were converted into 150,000 AOL Time Warner shares
- Their value on January 11, 2001 (day of deal closing): $6,585,000 ($43.90/share)
- Their value on July 1, 2002: $2,160,000 ($14.40/share)

Bernstein Global Wealth Management came up with some good calculations that further demonstrate the possible implications of accepting a stock deal versus a cash deal:

| | **"The Philanthropist"** | **"The Entrepreneur"** |
|---|---|---|
| Age | 52 | 52 |
| Family | Spouse, 3 grown children | Spouse, 2 grown children |
| Liquid assets (excl. business) | $10 million | $1 million |
| Allocation of liquid assets | 60% stocks/40% bonds | 60% stocks/40% bonds |
| Annual Personal Spending Needs | $350,000 | 500,000 |
| Time Horizon | 30 years | 30 years |
| Critical Goals for Sale Proceeds | $10 million to fund family foundation; supplement legacy | $10 million for new business venture; secure family's spending |
| Team Recommendation | Stock Deal | Cash Deal |

*Source: "The Art Before the Deal", Bernstein Global Wealth Management, a unit of Alliance Bernstein, L.P.

| | "Entrepreneur"- cash deal | "Entrepreneur"- stock deal |
|---|---|---|
| Initial Deal Value | $31.5 million | $35.0 million |
| Median value after 30 years (projection at time of closing) | 36 million | 53.2 million |
| Potential Downside+ (projection at time of closing) | 11.7 million | 0 (running out of money) |

*Source: "The Art Before the Deal", Bernstein Global Wealth Management, a unit of Alliance Bernstein, L.P.

As the above table shows, there is a chance that the "Entrepreneur" will run out of money if he accepts the stock deal. It is therefore recommended that he forgoes the potential upside of the stock deal and goes with the safer cash deal.

"The Philanthropist's" existing liquid assets at time of deal closing and the forecasted spending needs result in a 90% probability that he will still have at least $4million left after taxes, exclusive of the proceeds from the sale. This means that it is reasonably safe for him to go after the potential upside of a stock deal.

Many sellers are hesitant to accept stock deal because they are concerned about the associated risk. However, a variety of strategies exist that can significantly reduce the risk of a stock deal.

*Options for Reducing the Uncertainty of Stock Deals**

1. "Floor-and-ceiling" on the offer price: setting a minimum and maximum value that the seller will receive regardless of the acquiring company's stock price (e.g. minimum 85% and maximum 115% of stock price at closing)
2. "Fixed dollar value of stock": locking in the stock price at a fixed price
3. "Receiving a portion in cash"
4. "Hedging after the sale"/ "Establishing a Collar": a collar means that the seller of a company simultaneously sells a call (seller of a call is obliged to sell a commodity at an agreed upon date for an agreed upon price) and buys a put (a put allows the buyer the *right but not the obligation* to sell a commodity or financial instrument (the underlying instrument) at a certain time for a certain price)
5. Softening the lockup provisions/no lockup

*Source: "The Art Before the Deal", Bernstein Global Wealth Management, a unit of Alliance Bernstein, L.P.

*Establishing a Collar (Hedging) – Example*

| | **Share price after lock-up at $120** | **Share price after lock-up at $80** |
|---|---|---|
| Share price at closing | $100 | $100 |
| Amount of shares at closing | 200,000 | 200,000 |
| Call option (obligation to sell) for 200,000 shares at $100 | Will be exercised (by other party) | Will **not** be exercised (by other party) |
| Put option (right to sell) for 200,000 shares at $100 | Will not be exercised (by seller) | Will be exercised (by seller) |
| Result (value of seller's shares) | $20 million (original value) | $20 million (original value) |
| Result without collar | $24 million | $16 million |

Note: above example is for illustration purposes only. It ignores associated transaction costs.