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STRATEGIC HOSTILITIES IN CORPORATE FINANCE

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ABSTRACT

Hostility could drive strategic behavior. And corporate finance could provide an arena. Competitors, shareholders, credit raters or even governments could initiate the measure. Except for hostile takeovers, this hostile strategic behavior is seldom addressed within strategy frameworks. And is seldom related to a defensive profile or a repulsive strategic move.

The following article is an attempt at identifying the premises and framework of this hostile strategic behavior within corporate finance. The article gives a definition to corporate finance related strategic hostile behavior, explores the motivations, lists the players, analyses the strategies and explores possible defenses. An integrative conceptual and operational model follows.

The article is based on contemporary work on strategy as well as corporate finance. The conclusion, and the ensuing model, could have a far reaching applied value at both strategy formulation and corporate finance levels.

KEYWORDS: Corporate Finance, Strategic Hostility, Financial Planning, Financial Engineering

STRATEGIC HOSTILITY AND CORPORATE FINANCE?

A hostile act is an expression of aggression, anger or offense against an object in order to achieve a predetermined possibly malignant end result. Corporate finance strategies could assume a hostile dimension when they aim at undermining the continuity or the viability of the corporation. This could extend too many premises of corporate structure and performance going all the way from the asset base and capital framework to market value, credit worthiness, human resource and technology profile of the corporation.

There is a wide variety of hostility laden strategic behaviors but the one receiving most attention is hostile takeover. It connotes a takeover of equity base against the will or decisions of board, management or shareholders. It is possibly the most blatant and transparent variety. But the scope of hostilities is wide and could reach, as we will explain hereafter, too many corners of financial foundations of the corporation.

THE WHY?

Five drivers could drive a move towards hostile strategic behavior within a corporate finance framework.

1. A CONCENTRATION DRIVE

Concentration is a widely practiced corporate strategy today and it could take a hostile dimension. Seeking concentration is a strategic behavior whereby the player or players embark upon a merger and acquisition drive that would limit the number of competitors to a specific, high-concentration norm and create, in the process, forbidding entry barrier. A four-firm concentration ratio of 70 percent or above is considered, by the majority of standards, high, but can be found in key industries as beverages, autos and even investment banking in the United States and Europe. Among landmark corporations resorting to what appears to be a “seeking concentration” strategy today are Mittal Arcelor in the steel industry and Monsanto in seeds and agricultural chemicals (El Namaki, 2012).

2. END GAME CONDITIONS

Corporate hostilities could emerge as a result of a decline in industry and the emergence of end game conditions. Prime among the triggers are technology shifts, decline in demand and change in industry cost economies (Harrigan, 1983). A frequent strategic behavior, in a declining industry situation, is the acquisition of remnant operators and the building of a dominant market share that would exploit the very last segments of the vanishing industry. Hostile behavior here would take a variety of forms from outright acquisition to driving competitors towards forced exit. A behavior along these lines was developing in the mobile network industry for more than a decade (Booz et al 2002) and is emerging in the mobile device industry today.

3. DISRUPTIVE TECHNOLOGIES

A disruptive technology is a technology that radically alters or displaces an established technology and changes, in the process, industry fundamentals (Economist, Jan. 25, 2015). Disruptive technologies are in themselves hostile. By changing product traits, manufacturing technologies, cost economies, demand appeal, supply chain flow and even outlet fit, they introduce end game conditions to existing business frameworks and threaten their very existence. Illustrations are abounding. Cloud computing has replaced in-house resources and became a disruptive technology. Monetization of the mobile will have profound implications to industries as far away as consumer banking with far reaching disruption as a consequence.

4. GOVERNMENT ACTION.

Governments could exercise hostility through a wide variety of measures. There is the direct and obvious as excessive regulation and tight control and there is the indirect and even benign as the withdrawal of a tacit financial guarantees or the confinement of a task that is beyond the corporation’s ability to deliver. Dubai

World, a Dubai Emirate real estate developer ventured into large-scale leveraged real estate development under a guise of government support. . Dubai government's clarification that bonds issued by a subsidiary, Nakheel, did not have an explicit government guarantee led and a marked deterioration in Nakheel's finances. (IMF, 2012).

5. SHAREHOLDER REBELLION

Shareholders could become a source of hostile financial strategies if they, for a variety of reasons, decide to undertake adverse measures that could undermine corporate structure and/or operations. Shareholder can, for example, embark upon a pattern of concentrated equity selling that could depress share prices and undermine business continuity.

McGraw-Hill decision to split the corporation into two businesses one for education and the other for markets was the outcome of an act of shareholders hostility. Two active shareholders proposed the breakup in order to reverse "years of underperformance" (CNN Money, Dec 2011). The separation and the ensuing cost-cutting were signaled by the shareholders as remedies for a performance crisis. (Bloomberg Business, Sept 12, 2011)

THE WHAT: THE HOSTILE STRATEGIES.

What constitutes a strategic offense in capital related corporate finance

1. REVERSIBLE CAPITAL FLOWS.

Reversing a capital flow could constitute a strategic hostility. This could be associated with malignant or nonmalignant event. Demanding an earlier payment of a long term loan, terminating a revolving credit facility, converting a long term loan into a short term one and rapid selling of equity could all, within a context, be constituted as hostile moves?

The practice is common. In an extreme case, Apple recalled, in early 2015, an interest free loan extended to a sapphire material supplier, GT Advanced Technologies, on nonperformance grounds. Apple's $ 578 million loan to GT was part of a sapphire materials manufacturing agreement that allowed GT to operate at an Apple facility. The recalling of the loan was sudden and GT filed for bankruptcy the day after! (Business Insider, 10 June, 2014)

2. HOSTILE TAKE OVERS

Hostile takeovers connote aggression. The fact that a bidder attempts to take over a target company whose board, management, and possibly stockholders, are unwilling to agree to a merger or a takeover is an expression of hostility. Leveraged hostile takeovers, which are frequent, could spell excessive debt, greater liabilities and an added dimension to hostility.

Hostile takeovers and hostile leveraged takeovers are common, nevertheless. Way back in 2011 private equity firm Kohlberg Kravis Robert's conducted a hostile leveraged buyout of oil and gas firm Samson Investment at a cost of $ 7.2 Billion. A year earlier, Sanofi-Aventis acquired, at a cost of $ 24.5 billion, the biotechnology company Genzyme Corp (World Finance, 2014). Sanofi fought hard to consummate the takeover and had to offer significantly more per share than it initially wanted to ended up controlling a near 90 percent of its target company

3. MANIPULATIVE CREDIT RATING

Company credit rating provides a convenient, and potent, mode for corporate capital market aggression. An underrating would limit access to sources of capital and increase cost of borrowing. An unfounded overrating would mislead investors and create phony high risk investment climate. Market discounting of an overrated instrument would undermine the capital base of the corporation and, possibly, damage the very financial foundation of operations.

The highly concentrated global credit rating industry of today provides ample room for both the underrating and overrating strategies. And errors. Expert judgment contained within a credit rating, especially if it covers the sprawling structured finance variety, could contain an element of hostility through subjectivity, stimulation and ulterior motives. Over rating of mortgage rooted CDO' s or subprime bonds by all three lead operators within the credit rating industry (Moody's, Standard & Poor's and Fitch Ratings) in the years leading to the 2008 debacle , constituted what is , in reality, an explicit, hostile strategy (El Namaki, 2011).

4. COMPETITOR UNDERMINING

Raising doubts about a competitor's financial viability or related executive competency could constitute a strategic hostility. A viability attack could relate to the adequacy of the financial resource base, the market pricing of equity or the financial outlook of the corporation. The competency undermining might also refer to the overall performance of management or the specific ability of top management to deliver profitability, hold to a market share or to a product innovation.

The approach is common and has been practiced by recognized corporations. The CEO of the American Whole Foods Market Inc. wrote, for example, anonymous online attacks against a small competitor questioning the attractiveness of the equity and whether it provides a sound investment object. The goal, as it transpired later, was to undermine the competitors' equity and ease a takeover by Whole Foods. (NBC news, 2013)

A HOSTILITY ANTIDOTE?

A strategic hostility drive could either be averted or repulsed.

1. REPULSION STRATEGIES.

Those are essentially rejection strategies. Prime among them are the so called “poison pill” or internal cost triggers and “shareholder rights plans” or external equity ownership change.

A poison pill strategy is one that creates painful entry conditions for a takeover operator. A prohibitive cost that must be incurred once the takeover has taken place is the medium. This prohibitive cost could be induced in many ways. Overleverage is one, although it may adversely affect the price of equity. Employee stock ownership plans that would be triggered by the takeover is yet another. A non-financial poison pill would stagger the election of the board of a company, causing the acquiring company to face a hostile board for a prolonged period of time. In some cases, this delay in gaining control of the board (and therefore the votes necessary to approve certain key actions) is a sufficient deterrent for a takeover attempt.

Shareholders ' rights plans, would allow shareholders to purchase additional company equity at an attractive terms as soon as hostile acquisition intentions are announced . This would complicate the process of gaining majority equity possession by the raider.

2. AVERSION STRATEGIES

Those are anticipation and defense strategies. We will explore two: acquiring the acquirer and strategic control.

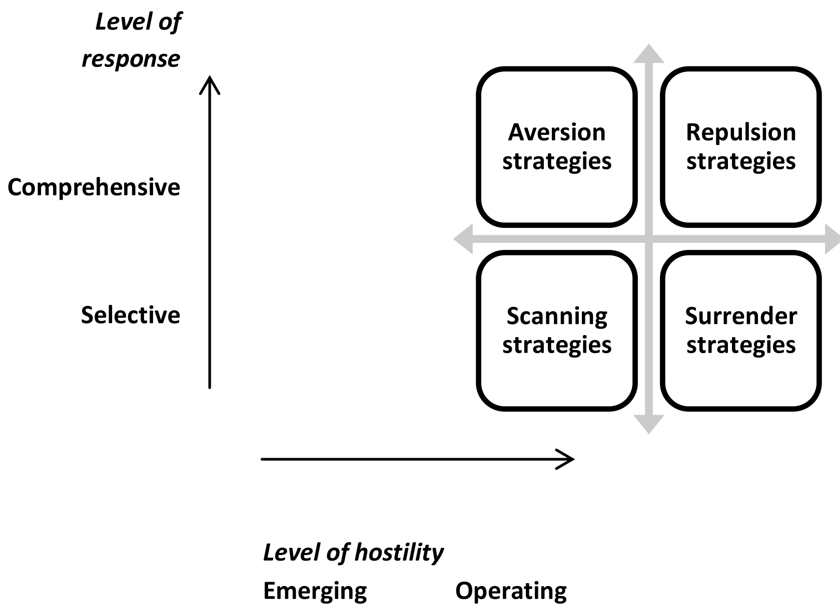
Acquiring the acquirer or mounting a bid to take over the raider is a “classic” aversion mechanism. This would require resources and shareholder support, however. This strategy has come to be called the Pac-Man defense, after Bendix Corporation's attempt to acquire Martin Marietta in 1982 (WSJ 26 Nov, 2013). The strategy has been less popular in recent years. Strategic control is control based on the potential rather than the achievable. Potential could point to an emerging threat especially with regards to the structure of the industry and the emergence of hostile takeover as a high probability event. This could especially occur within a high concentration industry where a market leader is seeking total dominance.

A HOSTILITY ANALYSIS?

Corporate finance hostilities could be contained within a framework that would identify a scope for action. The following diagram illustrates this situation.

Figure I

Phases of corporate finance hostilities and possible response



The two dimensions: level of hostility and type of response are segmented according to their specific criteria. Level of hostility is segmented into emerging hostilities and operating hostilities. Response is segmented into comprehensive and selective. Combination of the different states produces four strategies a scanning strategy, a repulsion strategy, an aversion strategy and a surrender strategy.

SUMMARY AND CONCLUSIONS.

Hostility could drive strategic behavior in corporate finance. Except for hostile takeovers, this hostile strategic behavior is seldom addressed within strategy frameworks .

The article explores the roots, the verities and ways and means of response to this hostile strategic behavior. Roots could lie in concentration drives, industry decline, government action or even shareholder rebellion. The varieties could go all the way from reversal of capital inputs and hostile takeover to credit rating manipulation and competitor undermining. Defense could connote repulsion or aversion. The hostility analysis suggested at the end of the article provides a framework for anticipation and reaction.

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