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Foreign Hostile Takeovers

and
the Hunt for Ericsson

Master's Thesis 2003

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Preface

The empirical study of this thesis is based on a study of foreign hostile takeovers in the Swedish stock market and an in-depth analysis of the situation of Telefonaktiebolaget LM Ericsson. The situation that we have investigated is quite new and there are few, if any, examples of similar situations in the Swedish business environment.

We find the subject of this thesis very interesting since it concerns a rare but sometimes very dramatic occurrence in the financial world. The subject lies on the borderline of the main financial theories taught during the economic and financial education at Gothenburg University. During the process of the work and as our understanding of the subject increased, our interest grew considerably. During the theoretical study, the work has several times been characterized by complexity depending on the vast range of definitions and different perceptions present along with the abstract nature of the subject. We would like to point out that this thesis does not intend to absolutely delimit or present definite answers to the problems that are stated. Instead, the underlying purpose is for the reader to acknowledge what this thesis illustrates as well as create a foundation for extended research.

We would like to show our gratitude towards all the employees of the companies who, despite a tight time frame, has participated in our research and have kindly received us. This thesis would not have had been possible to create without the support of Peter Rabe at Enskilda Securities AB and Ulf Aspenberg at Svenska Handelsbanken.

Pleasant reading!

Gothenburg, January 8 2004

Johan W. Apel

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Executive summary

Master's thesis, fall 2003

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Title: Foreign Hostile Takeovers and the Hunt for Ericsson

The main purpose of this thesis is to examine how the risk of a hostile takeover attempt on Ericsson is affected by the Swedish business environment. During the last century, a trend of centralization of businesses has emerged within many global markets. This trend has also affected Sweden; the country has experienced most M&A activity of all members of the European Union since the 1990's. Still, there is only a small and decreasing number of hostile takeovers on the Swedish stock market.

The authors perceive Ericsson to be a potential hostile takeover target, because of its significant reduced market value combined with the increased competition in telecom market. A case study of Ericsson is conducted and as a part of the thesis, it is including a company valuation. The work rests on the hypothesis that a potential takeover of Ericsson would be hostile and conducted by a foreign acquirer.

Ericsson was selected as the case study object since it reflects some important characteristics of the Swedish stock market that the authors wish to illustrate. The empiric study is based on six profound interviews with professionals, specialized in different areas relevant to this thesis.

The case study is delimited, only to examine companies with connections to the telecom market and especially Ericsson. The thesis only examines aspects of the Swedish stock market that are indicated by the respondents to affect a hostile takeover.

The hostility in a takeover situation is decided by the response of the management of the target firm. There are mainly three issues resulting in the modest and declining amount of hostile takeovers in Sweden. In many large Swedish firms, the ownership is constructed mainly by a few head owner who control a vast majority of the voting power. Another issue making hostile takeovers difficult is the Swedish system of dual share classes with different voting values. The decreasing rate of hostile takeovers is due to the fact that hostile responses to takeover offers have become political incorrect because of the share holder value mindset. The authors believe that Ericsson is an attractive takeover target but it is protected by the special properties of the Swedish stock market. However, no company is completely safe from a hostile takeover.

Table of contents

1	INTRODUCTION	0
1.1	DEFINITION AND DESCRIPTION OF ESSENTIAL TERMS	0
1.1.1	<i>Takeovers and Mergers</i>	0
1.1.2	<i>Hostile takeover</i>	0
1.1.3	<i>The Swedish stock market</i>	0
1.1.4	<i>Ericsson</i>	0
1.2	BACKGROUND	0
1.3	PROBLEM DISCUSSION.....	0
1.4	MAIN PROBLEM	0
1.4.1	<i>Sub-problems</i>	0
1.5	PURPOSE OF THE THESIS	0
1.6	DELIMITATIONS	0
2	METHODOLOGY	0
2.1	INTRODUCTION.....	0
2.2	RESEARCH METHOD.....	0
2.3	RESEARCH APPROACH.....	0
2.4	THE CASE STUDY.....	0
2.4.1	<i>Selection of case study</i>	0
2.5	DATA COLLECTION	0
2.5.1	<i>Qualitative interviews</i>	0
2.6	CRITICAL REVIEW OF SOURCES	0
2.7	CREDIBILITY	0
2.7.1	<i>Validity</i>	0
2.7.2	<i>Reliability</i>	0
3	THEORETICAL FRAME OF REFERENCE	0
3.1	TAKEOVER INCENTIVES.....	0
3.2	TYPES OF TAKEOVERS.....	0
3.2.1	<i>Horizontal and vertical mergers</i>	0
3.2.2	<i>Conglomerate, Strategic and Financial Takeovers</i>	0
3.2.3	<i>International takeovers</i>	0
3.3	THE HOSTILE APPROACH.....	0
3.3.1	<i>Defenses against hostile takeovers</i>	0
3.4	TAKEOVER STRATEGIES	0
3.4.1	<i>Conditional or unconditional tender offer</i>	0
3.4.2	<i>Secret accumulation of shares</i>	0
3.4.3	<i>Coercive offers</i>	0
3.5	VALUATION OF TAKEOVER TARGETS	0
3.5.1	<i>Free Cash Flow to Firm</i>	0
3.5.2	<i>Relative valuation</i>	0
4	EMPIRIC STUDY	0
4.1	THE HOSTILE APPROACH.....	0
4.1.1	<i>Accomplishment difficulties</i>	0
4.1.2	<i>Reasons for accomplishments and benefits</i>	0
4.2	HOSTILE TAKEOVERS IN SWEDEN.....	0
4.2.1	<i>Movements on the telecom market</i>	0
4.2.2	<i>Threats towards Ericsson</i>	0
4.2.3	<i>Valuation of Ericsson</i>	0
5	RESEARCH FINDINGS AND INTERPRETATION	0
5.1	THE HOSTILE APPROACH.....	0
5.1.1	<i>Difficulties</i>	0

5.1.2	<i>Prospects</i>	0
5.2	TAKEOVERS ON THE SWEDISH MARKET	0
5.2.1	<i>The telecom market and Ericsson</i>	0
5.2.2	<i>Valuation of Ericsson</i>	0
6	CONCLUSION AND END DISCUSSION	0
7	PROPOSALS TO EXTENDED RESEARCH	0
8	REFERENCES	0
8.1	SECONDARY SOURCES.....	0
8.1.1	<i>Literature</i>	0
8.1.2	<i>Company reports</i>	0
8.1.3	<i>Articles</i>	0
8.1.4	<i>Database articles</i>	0
8.1.5	<i>Online</i>	0
8.2	PRIMARY SOURCES.....	0
8.2.1	<i>Personal interviews</i>	0
8.2.2	<i>Electronic interviews</i>	0
8.2.3	<i>Telephone interviews</i>	0
8.2.4	<i>Seminars and lectures</i>	0
APPENDICES	0
	APPENDIX A: THE DEVELOPMENT OF THE LM ERICSSON STOCK	0
	APPENDIX B: THE TAKEOVER MARKET IN SWEDEN	0
	APPENDIX C: THE TEN LARGEST LISTED COMPANIES IN SWEDEN AND THEIR HEAD OWNERS 2002	0
	APPENDIX D: THE OWNER CONSTELLATION OF ERICSSON.....	0
	APPENDIX D: THE OWNER CONSTELLATION OF ERICSSON.....	0
	APPENDIX E: ERICSSON EXTENDED VALUATION PROCESS.....	0
	APPENDIX E: ERICSSON EXTENDED VALUATION PROCESS	0
	Moderate scenario	0
	High growth scenario.....	0
	APPENDIX F: ERICSSON VALUATION DATA	0
	APPENDIX F: ERICSSON VALUATION DATA	0
	Moderate scenario	0
	High growth scenario.....	0
	APPENDIX G: INTERVIEW FORM – INVESTMENT BANKS	0
	APPENDIX H: INTERVIEW FORM – ANALYSTS AND ERICSSON EMPLOYEES	0
	APPENDIX H: INTERVIEW FORM – ANALYSTS AND ERICSSON EMPLOYEES	0

List of figures

FIGURE 1: PRIMARY MOTIVES IN DIFFERENT KINDS OF TAKEOVERS.....	0
FIGURE 2; EXAMPLE OF A HOSTILE TAKEOVER PROCEDURE.....	0



1 Introduction

This chapter introduces the essentials of hostile takeovers, in addition to aspects of the Swedish stock market and the telecom market. Firstly, essential terms are defined and described to provide the reader with a fundamental understanding. Thereafter the main problem is stated supported by a discussion of the problem area. This chapter also covers an explanation of the purpose, method and delimitations of this thesis.

1.1 Definition and description of essential terms

For the reader to obtain the prerequisites of understanding this thesis, the initial part defines the most essential terms. The area of mergers and takeovers has been examined and documented by many experts over time which has led to an abundance of different views and theories. The authors are not proposing that some of those theories are wrong but in this section, the descriptions most correlated to the authors' views will be stated and used as definitions throughout this thesis. The view of the terms is perceived by the authors to be generally accepted.

1.1.1 Takeovers and Mergers

takeover [ˈteɪkəʊvə] **1** acquisition [of power]; occupation **2** [corporate] acquisition

merger [ˈmɜːdʒə] union; amalgamation

A *takeover*, sometimes called an *acquisition*, is one company's acquisition of control over another. The operation is usually carried out through a direct acquisition by one company of the net assets or liabilities of the other. The target company that is taken over is usually smaller than the acquiring company. An acquisition is normally carried out by means of buying shares in the company, with or without the approval of management. The fundamental purpose is to acquire more than fifty percent of the target firm's shares to effectively gain its control.¹ If the takeover is accepted by a sufficient percentile of the share holders of the target company, it may result in a *merger*.²

After a merger, the legal existence of the acquired organization is terminated and one less stock is publicly traded³. Things can sometimes be defined by what they are not, a merger is not the same as a consolidation, a joint venture, or a partnership⁴. Since the terms mentioned in this section are closely connected, M&A, short for mergers and acquisitions, is a commonly used term for the circumstances.⁵ In this thesis, by takeovers the authors refer to offers being given to companies listed on the stock exchange.

1.1.2 Hostile takeover

hostile [ˈhɒstəl] unfriendly [attitude]; unreceptive

takeover [ˈteɪkəʊvə] **1** acquisition [of power]; occupation **2** [corporate] acquisition

¹ Grinblatt, M., 2002, *Financial markets and corporate strategy*

² Ernst & Young, 1994, *Mergers & Acquisitions*

³ Grinblatt, M., 2002, *Financial markets and corporate strategy*

⁴ Weston, J. F., Chung, K. S., Siu, J. A., 1998, *Takeovers, restructuring, and corporate governance*

⁵ Weston, J. F., Chung, K. S., Siu, J. A., 1998, *Takeovers, restructuring, and corporate governance*



Takeovers are often categorized as being friendly or hostile. When the takeover bid, referred to as a *tender offer*, is handed directly to the firm's management or its board of directors is characterized as a friendly takeover. The tender offer is based on the bidders valuation of the target company⁶. However, the managers of the target firm sometimes object to being taken over which, if the bidding firm is persistent, makes the offer defined as hostile.⁷

In a hostile takeover the acquisition of control is usually effected by purchasing shares of the target company so that management and the board of directors can be bypassed. In these cases, the acquirer attempts to purchase sufficient shares of the target firm to gain a majority of the seats on the board of directors. Board members are then able to vote to merge the target firm with the acquiring firm⁸

The purchase may take place by agreements with individual shareholders, through stock exchange or by a tender offer. Therefore, hostile takeovers are in fact only a series of purchase of shares. The existence of several vendors in hostile takeovers causes various problems which would not be present if there were to be only one purchase of shares or the whole company was to be sold by only one vendor.⁹ Examples of attempts of hostile takeovers by Swedish firms are the bid that Volvo AB placed on Scania¹⁰ and the bid on the London Stock Exchange placed by Swedish OM-gruppen¹¹.

During the 1990's, the number of hostile takeovers declined substantially, only about 4 percent of the takeover bids were hostile and about 1/3 of them were successful¹². Analysts have been predicting over the last couple of years that corporate buyers and leverage buyout firms would go on shopping sprees as the economic downturn lowered the cost of acquisitions. A percentage of this increased activity could reasonably be expected to come in the form of hostile bids. There have been a number of hostile bids in the news recently, of this is a pure coincidence or the first signs of a new wave of hostile takeovers is to early to say.¹³

1.1.3 The Swedish stock market

The market of interest for the authors and this thesis is the Swedish stock market perceived in an international perspective. The market is defined as to consist of the companies listed on the A-list in the Stockholm Stock Exchange, *OM Stockholmsbörsen*.¹⁴ A motive for choosing the Swedish market is the fact that Sweden has experienced most M&A activity of all countries within the European Union since 1990¹⁵. According to mr Spence, however, the number of hostile takeovers in Sweden is low compared to international standards and decreasing¹⁶. Focus is also placed on the telecom sector. By "foreign" acquirers, the authors imply companies originated in other countries than Sweden.

⁶ Damodaran, A., 2002, *Investment valuation*

⁷ Grinblatt, M., 2002, *Financial markets and corporate strategy*

⁸ Mishkin, S. F. & Eakins, G. S., 2000, *Financial Markets and Institutions*

⁹ Savela, A., 1999, *Hostile takeovers and directors*

¹⁰ Augustsson, T., "Volvo i gryningsråd mot Scania", *Svenska Dagbladet*, January 16 2003, p. 24

¹¹ Gustafsson, S., "OM-gruppen lägger fientligt bud på Londonbörsen", *TT Nyhetsbanken*, August 29 2000

¹² Grinblatt, M., 2002, *Financial markets and corporate strategy*

¹³ Dolbeck, A., Growing Hostility: Unsolicited Takeovers on the Rise? *The Weekly Corporate Growth Report*, July 21 2003 p. 1-2, 12

¹⁴ <http://www.omgroup.com>, December 31 2003

¹⁵ Johansson, A., "Pagrotsky nöjd efter tuff runda – röstvärdet på aktier hotas inte längre av EU", *Göteborgs-Posten*, 28 November 2003 p. 32

¹⁶ Spens, J., Enskilda Securities AB, December 12 2003



1.1.4 Ericsson

The case study included in this thesis focuses on the Swedish telecommunications company Telefonaktiebolaget LM Ericsson, org. No 556016-0690, and its sub divisions. For practical reasons, the company will from now on be referred to as Ericsson.

Two essential terms under the circumstances are *producers* and *operators*. The authors' refer to producers as the companies which produces physical telecom equipment like mobile phones. Operators, on the other hand, are the companies which provide the telecom service to their subscribers. Ericsson is according to this definition a telecom producer.

1.2 Background

"No firm is regarded safe from a takeover possibility."¹⁷

During the last century, a trend of centralization of businesses has emerged within many global markets¹⁸. Over the years, the Swedish community has witnessed how several of its large domestic companies have been incorporated in international conglomerates. The consequences have been both good and bad, depending on the circumstances in each case, depending on the view of the observer. Recent examples are the takeover of Volvo Car Corporation by Ford¹⁹ and Pfizer's takeover of Pharmacia. The latter case is an example of the way an international takeover can affect the targeted company. Today, the headquarter office of Pharmacia based in Stockholm stands empty while its last business departments are being sold.²⁰ This is one of the cases where Swedish companies, after switching management, have moved their business to other countries with an economic climate more suitable to their owners.²¹ The semi takeover of the Swedish automobile producer SAAB by General Motors, on the other hand, is an example of positive influences a takeover can bring. The SAAB company would probably have gone bankrupt several years ago if it was not for the financial support from its U.S. investor.²²

The Swedish stock market has several characteristics that appears controversial to interested parties abroad. One of the main aspects is the system of having different types of shares holding different voting values. The shares holding the stronger voting value are usually called A-shares and the weaker are called B-shares. More recently started companies are not allowed to issue A-shares with more than ten times the voting value of the B-shares. However, as the case study of this thesis exemplifies, in Swedish companies registered before 1944 the A-shares could hold a voting value one thousand times larger than its B-shares. The purpose of having stock with different voting values is to be able to raise stock capital by tendering the weaker kind of shares to other investors without declining the voting majority.²³

¹⁷ Weston, J. F., Chung, K. S., Siu, J. A., 1998, *Takeovers, restructuring, and corporate governance*

¹⁸ Porter, M., "Competitive strategy", September 19 2003

¹⁹ Bergström, T., "Ford köper Volvo personvagnar för 50 miljarder", *TT Nyhetsbanken*, January 28 1999

²⁰ Åkerberg, N., "Pfizer tog över allt", *Dagens Industri*, October 6 2003, p. 6-7

²¹ Mardbant, C., "Dra lärdom av Pharmacia", *Dagens Industri*, October 6 2003, p. 1

²² Brandes, O. & Lövgren, S., "De mindre företagen behöver näring", *Göteborgs-Posten*, December 5 2003, p. 4

²³ Lundén, B, 2001, *Aktiebolag*



The Swedish system of having different kinds of stocks is closely linked to the somewhat unordinary owning constellation that the country is known for. Over the years, the Swedish investment market has been dominated by a few large owners, some of which are still existing. Their history goes back a long time and so does their relationship with their investment project. The Investor, controlled by the Wallenberg family and Industrivärden, controlled by Svenska Handelsbanken are perhaps the most commonly mentioned but they are not the only ones. There are also several foundations that possess large holdings in several of the country's companies. This type of ownership differs to some extent from traditional funds. According to Mr Spence, these funds represent a large amount of customers and their goal is to maximize turnover. When the ownership is controlled by single families and foundations other incentives than turnover sometimes do exist.²⁴ The Wallenberg for example, has rescued Ericsson three times; once from bankruptcy and twice from the American company ITT²⁵.

Ericsson is the world's largest supplier of infrastructure for mobile phones²⁶. In addition, the company owns 50 percent of the mobile phone company Sony Ericsson Mobile Communications in a joint venture with Sony. SEMC is today a quite small part of Ericsson's business but of great importance in the future due to the expectations of an increasing growth. However, according to Ericsson's third quarter report of 2003, it is today one of the few divisions that generates a positive cash flow.²⁷ Like several large Swedish companies, Ericsson is primarily owned by a few investors²⁸. Two power blocks based on Investor, controlled by the Wallenberg family and Industrivärden, controlled by Svenska Handelsbanken, possess the main control of Ericsson aided by the old Swedish rule of having dual classes of shares. The rule is fully utilized by giving its A-shares one thousand times the voting power of the B shares.²⁹ Jointly, the Wallenberg family empire and Svenska Handelsbanken represent more than seventy percent of the votes in the company, even though they only possess less than ten percent of the stock capital³⁰.

Because of the economic downturn in the telecom market following the turn of the millennium; Ericsson suffered substantial losses in stock value. In February 2000, the company had reached its highest levels in stock price ever. However, in late September 2002, the stock price had dropped 97,38 % leaving the company with severe financial difficulties³¹. According to Ericsson, the situation forced the company to go through severe restructuring; non-core products and services were outsourced to partners and discontinued or sold to others. Additional steps were reductions of excess capacity costs and overhead costs, workforce reductions, transfer of production to countries with lower costs and merging many of its subsidiaries to reduce operating expenses. In the financial market environment, the company managed to secure additional funding through a stock issue.³² Today, after these emergency actions, Ericsson has gained some strength on the stock market but the stock price is still only a few percent of what it once was.

²⁴ Spens, J., Enskilda Securities AB, December 12 2003

²⁵ Guyon, J. & Hjelt, P., "How Do You Say DYNASTY in Swedish?", *Fortune* magazine, May 14 2001, Vol. 143, Issue 10 p. 70-73

²⁶ Brown-Humes, "Ericsson in talks over changing share structure", *The Financial Times Limited*, November 21 2003, pg. 23

²⁷ Ericsson, *Third quarter report*, 2003

²⁸ Appendix C: The ten largest listed companies in Sweden and their head owners 2002

²⁹ Brown-Humes, "Ericsson in talks over changing share structure", *The Financial Times Limited*, November 21 2003, pg. 23

³⁰ Appendix D: The owner constellation of Ericsson 2002

³¹ Appendix 1a; The development of the stock price of Ericsson

³² Ericsson, *Annual Report 2002*, 2003



The telecom market is well known for its turbulence and its players actively searching for new ways of gaining market power³³. During the 1990's, the telecommunications industry experienced heavy M&A activity which has made it become an industry with relatively few but large vendors and customers. Indeed, in a number of research papers, the telecommunications sector was ranked as one of the top industries for M&A activity during the 1990's. Some analysts claim that the M&A frenzy was due to deregulation within the telecom sector and also as a response to the opportunities presented by ongoing changes in technology such as the growth of the Internet and fiber optics. There are no signs of the M&A activity of the 1990's not continuing beyond year 2000.³⁴

Deregulation and technological change jointly create new business opportunities for incumbent firms in an industry, as well as for potential newcomers. One way to take advantage of such opportunities is through in house production. An alternative is to enter a new opportunity by taking over another firm. Such a choice will arguably be based on transaction cost considerations. The takeover route is often the least-cost response to deregulation and technological change.³⁵

The recent developments have made the telecom market expand at an increasing speed and in some cases to approach other markets. The climate has become more dynamic, the recent changes have brought in new playing rules affecting the balance of power on all parts of the telecom market. Perhaps the most important change is that large global operators, like Vodafone and Orange, have begun to challenge the brand and position of the mobile phone producers. With their power of world-wide coverage and millions of customers, they are not to be belittled. The operators are exceedingly offensive in the hunt of new profits and the control of the customers. The operators desire the mobile phones, both on the inside and outside. "*We have developed a global brand that brings all products and services together*", says Jon Earle, official spokesman of the Vodafone Group in Great Britain. The mobile phone producers and operators are watching each other closely in the long perspective, despite the current close relation. At the present time, both parties enrich each others business, but what will the situation be like tomorrow?³⁶

Europolitan was once one of the major telecommunication providers in Sweden, owned by the American communications company Airtouch. After a fearsome bidding battle between MCI Worldcom, Vodafone and Bell Atlantic³⁷, Airtouch was bought by Vodafone³⁸. The fifty billion dollar deal is only one of several multi billion takeovers undertaken by Vodafone over the last years. In February 2000 Vodafone pulled through a hostile takeover of Mannesmann, a major German telecommunication company which at the time was the world's largest merger deal ever, reaching over two hundred billion dollars³⁹. During the process, there were heavy discussions between the share holders and the management of Mannesmann. Some of the shareholders applied for a temporary injunction to stop Mannesmann's managers from blocking a higher offer from Vodafone.⁴⁰

³³ Weston, J. F., Mitchell, M. L., Mulherin, J. H., 2003, *Takeovers, restructuring, and corporate governance*

³⁴ Weston, J. F., Mitchell, M. L., Mulherin, J. H., 2003, *Takeovers, restructuring, and corporate governance*

³⁵ Weston, J. F., Mitchell, M. L., Mulherin, J. H., 2003, *Takeovers, restructuring, and corporate governance*

³⁶ Carlbom, T., "Högt spel", *Veckans affärer*, November 17 2003, p. 24-34

³⁷ Stenberg, K., "Svenska teleoperatörer pressas av stor teleaffär", *Finanstidningen*, January 8 1999

³⁸ Wennerström, F., "Europolitan får ny ägare", *Göteborgs-Posten*, January 19 1999

³⁹ Björk, M., "Världens största affär i hamn", *Dagens Industri*, February 04 2000, p. 4

⁴⁰ "Business This Week", *Economist Newspaper Limited*, December 11 1999, Vol. 353 Issue 8149, p. 5



The conventional GSM market is no longer a cash cow and the attention of the telecom market is now directed towards the future. The level of competition on the mobile phone market might skyrocket once the next generation concept, 3G, gets established since it opens up the doors for complete international competition. The standards of 3G are global which means that Asian producers, who formerly only concentrated on their domestic markets, suddenly has a global business scope. Today, one third of the world's mobile phone production is in China where the costs are about 40 percent lower than in the western world.⁴¹ The 3G market is expected to get established sometime near 2005.⁴²

The software or operational system of the phones has become an increasingly important tool. The mobile phone market is closely monitored by software corporations, especially Microsoft that would like to reiterate its revolutions once again. Carl Backman, director of the IT-department at Swedish Bure, concurs with the idea that Microsoft might want to cover a wider range such as including the mobile phone market⁴³. Microsoft challenges the whole mobile phone market with its own operational system and the market players, primary Nokia does all in their powers to counteract⁴⁴. Linux is another interested party. IT and telecom are synthesizing because of the 3G concept and giants like Microsoft are not hesitating to confront the major mobile phone producers.⁴⁵ One recent example of the emerging trend was the surprising forming of an alliance between Vodafone and Microsoft to compete Nokia⁴⁶. "We will invest, invest and keep on investing until we have succeeded in the mobile market", was a recent comment by Bill Gates⁴⁷. The occurrence is likely to also effect Ericsson since Nokia is the main competitor in the mobile phone segment.

A company that is possibly posing a threat to Ericsson is cash rich U.S. telecom equipment powerhouse Cisco Systems Inc⁴⁸. This is one of the most cited candidates since its areas of expertise correlates in many ways with those of Ericsson. In addition, Cisco has a history of expanding through frequent acquisitions due to its aggressive strategy.⁴⁹

Even though Ericsson has gone through severe restructuring, it has been of great concern not to let the cost cutting harm the company's core products and services. According to Ericsson, the company processes highly desirable resources – for example a global network of customers, a strong brand name in both the mobile phone industry and the fixed communication segment, technical competences and one of the strongest patent portfolios in the telecom industry⁵⁰. The company has a history of producing innovations that revolutionized the market, i.e. the GSM-technology, Bluetooth and also parts of the 3G-technology⁵¹.

1.3 Problem discussion

Until recently, November 27 2003, the Swedish voting system was threatened by the European Union takeover directive. The directive aimed at discharging the dual classes of

⁴¹ Carlbom, T., "Högt spel", *Veckans affärer*, November 17 2003, p. 24-34

⁴² Carlbom, T., "Högt spel", *Veckans affärer*, November 17 2003, p. 24-34

⁴³ Backman, C., Director of the IT-department, Bure, Stockholm, November 24.2003

⁴⁴ TT, "Kampen om mobilmarkanden hårdnar", *Dagens Industri*, December 30 2003

⁴⁵ Carlbom, T., "Högt spel", *Veckans affärer*, November 17 2003, p. 24-34

⁴⁶ Carlsson, B., "Striden om mobilens inkråm trappas upp", *Dagens Nyheter*, October 19 2003, p. 28

⁴⁷ TT, "Kampen om mobilmarkanden hårdnar", *Dagens Industri*, December 30 2003

⁴⁸ Pringle, D., "Ericsson Draws Takeover Talk", *The Wall Street Journal*, July 2 2002, p. 12

⁴⁹ Weston, J. F., Mitchell, M. L., Mulherin, J. H., 2003, *Takeovers, restructuring, and corporate governance*

⁵⁰ Ericsson, *Annual Report 2002*, 2003

⁵¹ <http://www.ericsson.com>, 2001



stocks that are present in the Nordic countries. According to Dagens Nyheter this would have resulted in some of the major companies of Sweden, Ericsson for example, being exposed to a takeover threat that the traditional head owners would have little power to affect.⁵²

In addition, a recent debate has emerged after a proposal from the leading shareholders concerning the controversial voting structure of Ericsson. A success of the proposal would see Ericsson abandon its system that gives it's a shares one thousand times the voting rights of its B shares. Instead A shares would carry ten times the votes of B shares. The move would reduce the influence of both the Investor and Industrivärden over Ericsson; cutting their combined voting power to about forty percent. Foreign shareholders would see their voting power rise sharply to about twenty-five percent. According to Jan Irfelt⁵³, the change would give much voting power to interested parties with pure economic interests and less political, like the head shareholders. In turn, this would increase the potential for a hostile takeover.⁵⁴ At the moment, Ericsson's voting structure is what's putting potential bidders off.⁵⁵

Some observers say the proposal does not give adequate compensation to A shareholders who may challenge it. B shareholders believe they were promised a reform of Ericsson's voting system last year when the company was seeking support for its four billion dollars rights issue. This could leave the company facing a backlash, particularly from foreign shareholders, if the issue is not resolved.⁵⁶

As described, the environment surrounding Ericsson is changing rapidly. Former allies are turning into competitors, striving to control the whole entity that they used to generate in cooperation. Adding more complexity to the situation, new parties are approaching the perimeters of Ericsson's market, which is already under heavy pressure. Operators like Vodafone and Orange are closing in from one direction, software specialist like Microsoft and Linux from another accompanied with other network suppliers like Cisco. Once the 3G technology is fully established the conditions for surviving might go through severe changes giving way for global competition and also providing an opportunity for new parties to join in.⁵⁷

Because of the company's reputation and its resources combined with a decreased equity market value, Ericsson presents an opening to enter the telecom market regarding both the mobile phone and the mobile network section. "Ericsson is a steal at its current share price" was a comment made by an analyst with the Dresdner Kleinworth Wasserstein investment bank⁵⁸. However, the special characteristics of the Swedish stock market might provide the protection that Ericsson needs to stay independent, but is this going to last and to what benefit? In a world striving towards unity and where trade hindrances are being removed, old controversial systems are having a hard time to justify their purposes. The proposal of changing the voting structure amongst the Ericsson's shareholders would benefit a potential

⁵² Johansson, A., "Pagrotsky nöjd efter tuff runda – röstvärdet på aktier hotas inte längre av EU", *Göteborgs-Posten*, 28 November 2003 p. 32

⁵³ Irfelt, J., Swedbank, Stockholm, November 24 2003

⁵⁴ Brown-Humes, "Ericsson in talks over changing share structure", *The Financial Times Limited*, November 21 2003, p. 23

⁵⁵ Pringle, D., "Ericsson Draws Takeover Talk", *The Wall Street Journal*, July 2 2002, p. 12

⁵⁶ Brown-Humes, "Ericsson in talks over changing share structure", *The Financial Times Limited*, November 21 2003, p. 23

⁵⁷ Carlbom, T., "Högt spel", *Veckans affärer*, November 17 2003, p. 24-34

⁵⁸ Pringle, D., "Ericsson Draws Takeover Talk", *The Wall Street Journal*, July 2 2002, p. 12



acquirer in addition to the severely reduced market value. Amid the increase of competitive pressure, there is a consensus that the industry needs to consolidate⁵⁹.

The authors find the perception of there being a relatively low and decreasing number of hostile takeovers in Sweden despite the country's high level of M&A activity, very interesting. Therefore, the authors want to investigate how the Swedish business environment affects the hostile takeover situation in a specific case, where Ericsson was chosen. Since Investor, who possess the largest voting power, will probably not tender their shares to a foreign bidder. It is also unlikely that an acquirer would be a Swedish company since there are few who possess the necessary resources. Because of these hypotheses, the authors estimate a foreign, hostile takeover of Ericsson to be the most likely scenario.

1.4 Main problem

- How is the risk of a hostile takeover attempt on Ericsson affected by the Swedish business environment?

1.4.1 Sub-problems

- What is hostile in a hostile takeover and why are they conducted? Does the perception of the issue differ between theory and professionals?
- What are the main reasons for the number of hostile takeovers in Sweden being quite low and decreasing, according to investment bankers? How are these reasons affecting Ericsson?
- In the current situation, is Ericsson likely to be a hostile takeover target? What corresponds and contradicts to such a situation occurring? Is Ericsson correctly valued by the market?

1.5 Purpose of the thesis

The purpose of this thesis is to examine how the risk of a hostile takeover attempt on Ericsson is affected by the Swedish business environment.

1.6 Delimitations

This thesis does not claim to present an absolute answer to the questions stated, but high quality conclusions by the authors. The aspiration is to keep a neutral perception through out the work process. Due to restrictions in time and the resources at hand, the authors have had to delimit the study in certain aspects.

The legal issues of takeovers and mergers, as well as the contractual aspects are both important issues in investigating and fully describing the situation. However, the authors only cover the legislative issues that are closely connected to relevant issue in this thesis. For example, the fundamental principle of the Swedish legislation concerning limited companies is that all stocks shall be traded freely with only a few exceptions for special circumstances. Since none of these circumstances are applicable in the case of Ericsson this thesis will not investigate the issue any further.⁶⁰

⁵⁹ Pringle, D., "Ericsson Draws Takeover Talk", *The Wall Street Journal*, July 2 2002, p. 12

⁶⁰ Lundén, B, 2001, *Aktiebolag*



2 Methodology

The purpose of this chapter is to present and motivate the authors' choice of research method and approach as well as the process of data collection. The case study will also be accounted for along with the adherent selection process. The chapter is concluded with an account for its credibility, which is discussed supported by the terms of validity and reliability.

2.1 Introduction

Different kinds of studies demand different kinds of methods to generate a reliable solution. According to theory, it is the question at issue that should decide which method or methods that should be applied. Mistakes could result in the creation of false information.⁶¹

A good knowledge of methodology provides the possibility of conducting an efficient investigation no matter what the subject is. There fore, the choice of method is very important during the investigation process.⁶² One way of defining the meaning of method is to compare it to close related terms and make distinctions. There is one distinction between method and technique. In this case, method is the way in which the scientific process is conducted while technique is a definition of the specific procedures that have been adapted in the different situations. The term gets a more specified meaning in expressions like "quantitative method", "experimental method" and such.⁶³ As a conclusion, the term method could be described as "a way of accumulating information". This interpretation indicates that it is important to consider which method to choose even before the field work is initiated.

2.2 Research method

Since the purpose is to thoroughly explain the nature of foreign hostile takeovers in Sweden by investigating the situation of an existing company, most of the research has been conducted with a qualitative approach. However, the study includes several quantitative parts, foremost concerning the valuation of Ericsson. A qualitative method, compared to a quantitative method, does provide more flexibility in the work process. According to theory, qualitative methods often lead to modifications of the presentation of the problem. This is partially a result of increased knowledge about the subject that the research concerns and partially because situations of interest can change during the process.⁶⁴ In a qualitative research, the conclusions are mainly based on non quantified data like for instance attitudes, values and opinions.⁶⁵ Considering the purpose and the presentation of the problem in this thesis, a general qualitative character is suitable of the approach.

2.3 Research approach

At an early stage it was decided among the authors that this thesis would deal with hostile takeovers in the Swedish environment. It was decided to look closer on the fact of there being very few hostile takeovers in Sweden, even in businesses that are characterized by

⁶¹ Holme, I. M., Solvang, B. K., 1991, *Forskningsmetodik: om kvalitativa och kvantitativa metoder*

⁶² Wiedersheim-Paul, F., Eriksson, L., 1991, *Att Utredda, Forska och Rapportera*

⁶³ Rosengren, K. E., Rosengren, P., 1992, *Sociologisk Metodik*

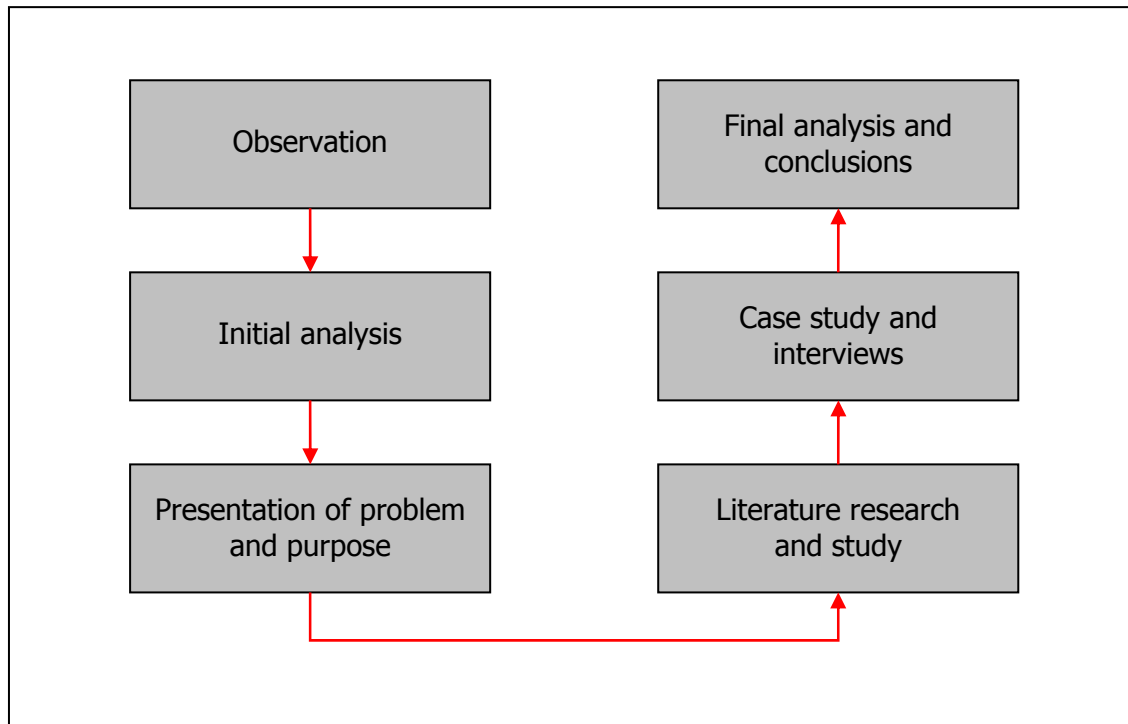
⁶⁴ Jensen, M., 1995, *Kvalitativa Metoder*

⁶⁵ Lundahl, U., Skärvad, P-H., 1992, *Utredningsmetodik för Samhällsvetare och Ekonomer*



such. Two investment banks were contacted and agreed to give the authors assistance by supplying information about the relevant elements. Later on, a case object was determined that was contacted and also offered its support. The respondents were chosen by a non-probability sampling, which means contacting people with knowledge of areas of importance for fulfilling the purpose of this thesis.⁶⁶

Figure 1 Work model⁶⁷



2.4 The case study

The authors choose to conduct a case study regarding hostile takeovers in Sweden because of several reasons. Firstly, it is interesting to apply the existing theory in hostile takeovers on an existing company to concretize the problem issue. There has also been a discussion about Ericsson as a takeover target for some time now because of the volatile market it is in combined with a vastly diminished market value which implies a low price for Ericsson's core values. It has also been a hard time for Ericsson shareholders. A hostile takeover would bring up an evaluation of the performance of Ericsson's managements. It is not unlikely that a management in some other company believes that it can manage Ericsson in a more profitable way. All these things together make it interesting and relevant to conduct a case study on Ericsson. In addition, the authors find it valuable in their effort to try to explain the characteristics and function of hostile takeovers and the Swedish environment to the reader.

2.4.1 Selection of case study

When choosing an case to analyze it is usually a question of delimitation, defining what that case study and its boundaries are.⁶⁸ The selection process for this thesis was initiated by stating basic criterion and subsequently looking for matching objects. The basic criterions for choosing Ericsson were:

⁶⁶ Wiedersheim-Paul, F., Eriksson, L., 1991, *Att Utreda, Forska och Rapportera*

⁶⁷ Created by the authors

⁶⁸ Backman, J., 1998, *Rapporter och uppsatser*



- **Ericsson is a corporation founded and registered in Sweden.** This choice was made for three reasons; Swedish corporations are of great interest for both the authors and its intended audience. Swedish companies are the easiest to get in touch with considering travel distance and related aspects. Also, since the authors are educated in Sweden their expertise lies on Swedish business methods and legislation.
- **Ericsson is traded on the Swedish stock market.** This is essential since the authors are interested in how the Swedish stock market affects the risk of hostile takeovers.
- **Ericsson is controlled to a large extent by domestic investors.** This criteria is closely related to the prior one. Domestic investors are the ones the authors have most knowledge about and are, as the object of choice, easy to access. A Swedish company to a large extent owned by foreign investors does not correlate to our view of a pure Swedish company.
- **It is possible that Ericsson could be a potential target for a hostile takeover.** This situation creates interesting circumstances to analyze and will provide a good fundament to apply existing theories upon. There is a public discussion, about the takeover possibility of the company.
- **Ericsson is well known and of considerable size.** This reason is not essential to the main propose of this thesis. However, a takeover threat towards Ericsson would have significant impact on the Swedish business environment and labour market which makes it relevant and interesting to the reader.

In addition, there have been internal discussions about rearranging Ericsson's voting system with dual share classes. Similar is the situation for the entire Swedish share system that is under discussion because of new European Union directives. Another important reason for focusing on Ericsson is that the company is acting on one of the most turbulent global markets regarding M&A activities – the telecom market.

In the relative valuation of Ericsson, the selection of comparison companies is based on indications made by market analysts, in connection with the conducted interviews. The current discussion in media has also influenced the selection process.

2.5 Data collection

According to theory, there is a distinction between two kinds of data of which both were used in the investigation which this thesis is based on.⁶⁹ Secondary data is collected by other researchers and is accessible in form of books, specialist articles, the Internet et cetera. The primary data used by the authors is based on qualitative interviews.

2.5.1 Qualitative interviews

The purpose of the interviews was to achieve a profound knowledge about Swedish business environment, the telecom business and the situation of Ericsson. The questions for the interviews were created with one specific question form for the investment banks, one for analysts and one for the staff of Ericsson. By doing this it has been possible to perform the interviews in a way in which the respondents' professional knowledge was targeted.

The forms have been sent to the respondents via email in advance of the interviews. This gave the respondent time to prepare and be able to gather the relevant information. The

⁶⁹ Rosengren, K. E., Rosengren, P., 1992, *Sociologisk Metodik*



data collection during the interviews was made by recording on MiniDisc. This was suitable in order to be focused on the questions and the respondent.

All interviews were conducted by structure of the question form, but with an open nature of the questions that generated new and unforeseen information during the interviews. This kind of interview method is called qualitative interview.⁷⁰ As implied by the name, the qualitative interview is suitable for collection of information that is hard to gather in other ways. There were six main interviews conducted, based on a reliable selection. The respondents can be divided into three categories:

- Analysts and specialists on the topic of the Swedish market and telecom, belonging to public or government institutions. (2 respondents)
- Analysts and specialists on the subject of takeovers (3 respondents)
- Ericsson vice president responsible for Investor Relations (1 respondent)

Depending on their importance and availability, there were also follow up interviews conducted, either via telephone, e-mail or in person.

2.6 Critical review of sources

The critical review of sources can be seen as a method of selection where the collected material is evaluated. The theories used in the frame of reference are based on established literature and current articles. The literature has been attained, partly from recommendations from the master thesis course homepage, partly from searching literature at the Economic Library at the School of Economics and Commercial Law at Gothenburg University. This is also where the most articles were found by searching databases. The most used key words in the searches were: "Hostile", "Takeover", "Swedish stock market", "aktiebolagslag"⁷¹, "dual share class system", "Telecom", "Ericsson", "M&A", and combinations of the words. One might have remarks concerning the width of the literature search but the authors perceive it to be sufficient due to the time limits and the scope of a Master's thesis.

Concerning the sources referring to the internet, there is no simple way to investigate their authenticity. These references should be viewed with a critical mindset. However, most of the internet references are well known and well established financial sites.

The interviews can of course be criticized for their relatively small scope. The answers gathered by interviews reflect the respondents' subjective opinion and another filter is the effect of the interviewer⁷². These may reduce the information's validity. It is impossible for the authors to know whether the respondent are truthful or not, or withhold relevant information. Certain questions may also contain sensitive information that the respondent will not share with the interviewer. The authors also find it reasonable to believe that the respondents representing Ericsson do deviate from the other respondents concerning the objectivity on issues about the company.

2.7 Credibility

An investigation can contain errors depending on flaws in the selected method. Are the chosen individuals representative for the problem and purpose of this thesis? Other kinds of

⁷⁰ Jacobsen, J., 1993, *Intervju – Konsten att Lyssna och Fråga*

⁷¹ Swedish for "limited company legislation"

⁷² Wiedersheim-Paul, F., Eriksson, L., 1991, *Att Utreda, Forska och Rapportera*



errors that may arise are flaws in the selected measuring instrument.⁷³ If the chosen measure instrument is not appropriate there will be measurement errors, which involve errors in the chosen measurement method. Errors that arise can be related to mainly two kinds, validity and reliability.

2.7.1 Validity

A simple and common way to define validity is to say that a valid measurement measure what it is supposed to measure.⁷⁴ The question is if the authors really have managed to determine the current situation concerning hostile takeovers in the Swedish market and the situation of Ericsson. Does the respondents perception of the circumstances concur with the one presented by the authors?

To secure the legitimacy of the results of this work the authors have tried to contact several individuals within the area of interest. The interviews have been conducted with both internal and external interested parties of Ericsson and also of the Swedish market. In this way, individual deviant viewpoints could be distinguished from accepted facts. The theoretical frame of reference is based on a scientific frame of reference.

2.7.2 Reliability

Validity is the most important requirement on an instrument, an interview form for instance. If the instrument does not measure what is supposed to be measured, it does not matter if the measurement is good or not. Reliability could be perceived as an additional requirement, controlling that the instrument of measurement gives reliable and stable readings.⁷⁵

Reliability refers to the ability of the measurement to avoid the influence of randomness.⁷⁶ Measurement errors due to randomness could be assigned to four different sources:⁷⁷

- The instrument (formulation of the question)
- The interviewer (the individual conduct during the interview)
- The environment of the interview (disturbing elements)
- The respondent (the respondent could make mistakes, be tired et cetera)

Because of the interview method being used, supplying the questions in advance in addition to using a MiniDisc recorder, the authors are confident in having avoided these factors of randomness. During the process, the authors' interpretation of the interviews, as presented in chapter four, has been sent back to the respondents to secure their accuracy. These steps makes the authors conclude that the reliability is satisfactory

⁷³ Wiedersheim-Paul, F., Eriksson, L., 1991, *Att Utredda, Forska och Rapportera*

⁷⁴ Rosengren, K. E., Rosengren, P., 1992, *Sociologisk Metodik*

⁷⁵ Rosengren, K. E., Rosengren, P., 1992, *Sociologisk Metodik*

⁷⁶ Wiedersheim-Paul, F., Eriksson, L., 1991, *Att Utredda, Forska och Rapportera*

⁷⁷ Rosengren, K. E., Rosengren, P., 1992, *Sociologisk Metodik*



3 Theoretical frame of reference

This chapter presents a framework for understanding the many aspects of takeovers under hostile and friendly circumstances. The theoretical fundamentals described in the introduction will also be explained in an in-depth fashion. When describing the different kinds of mergers, the authors has chosen to place the emphasis on conglomerate combinations since that is most essential to the matter of this thesis. Finally, theory concerning valuation of takeover targets will be presented since it is a fundamental step in a takeover process. The valuation theory is applied in chapter 5 to value Ericsson.

3.1 Takeover incentives

In most cases, the acquiring firm offer to buy the target's shares at a substantial premium over the target's prevailing stock price. Takeover premiums generally range from 50 percent to 100 percent of the target firm's share price before the acquisition.⁷⁸ This section describes value-increasing theories that motivate firms to offer such large premiums to acquire existing companies.

A common feature of all mergers is an increase in firm size. Consequently, a standard reason offered for a merger is that the union of the two firms will create economies of scale or synergies. One natural economy of scale occurs in holding inventories when demand is subject to random influences. The statistical law of large numbers maintains that the larger the scale of operation is, the lower the required investment in inventories is in relation to the average quantity sold. Another important source of returns to scale is specialization. This was observed by Adam Smith in his famous example of producing pins. Firms of larger size might be able to organize production into specialist groups that emphasize a single task. Such gains suggest one reason why growing industries often experience mergers.⁷⁹

Returns to scale can be distinguished from improved capacity utilization that spreads fixed costs over a larger number of units. In some industries, consolidating mergers have taken place to reduce industry capacity. Technological change is often one of the main reasons for this situation.⁸⁰ Another incentive for acquisitions is to generate economies of scope which enable a firm to produce related additional products at a lower cost because of experience with existing products.⁸¹

The nature of takeovers and the effects they cause is a thoroughly explored area but still there are few models and facts that are undisputed.⁸²

Mergers and acquisitions may be critical to the healthy expansion of business firms as they evolve through successive stages of growth and development. Both internal and external growth may be complementary in the long-range evolution of firms. Successful entry into new product markets and into new geographic markets by a firm may require mergers and acquisitions at some stage in the firm's development. Successful competition in international

⁷⁸ Grinblatt, M., Titman, S., 2002, *Financial markets and corporate strategy*

⁷⁹ Weston, J. F., Mitchell, M. L., Mulherin, J. H., 2002, *Takeovers, restructuring, and corporate governance*

⁸⁰ Weston, J. F., Mitchell, M. L., Mulherin, J. H., 2002, *Takeovers, restructuring, and corporate governance*

⁸¹ Weston, J. F., Mitchell, M. L., Mulherin, J. H., 2002, *Takeovers, restructuring, and corporate governance*

⁸² Weston, J. F., Chung, K. S., Siu, J. A., 1998, *Takeovers, restructuring, and corporate governance*



markets may depend on capabilities obtained in a timely and efficient fashion through mergers and acquisitions. Some have argued that mergers increase value and efficiency and move resources to their optimal uses, thereby increasing shareholder value.⁸³

An alternative theory regarding why a takeover transaction creates value is based on disciplinary motives. Corporate takeovers could be perceived as an integral component of the market for corporate control. The takeover market facilitates competition among different management teams. If the executives at a given firm are viewed as responsible for poor performance, another firm or management team can use an acquisition to remove the existing officers and thereby improve the performance of the acquired firm's assets.⁸⁴

It is possible that the acquiring firm is willing to pay a premium for a target because the bidder's management believes that the target is worth more than its current market value. The theory does, in other words, rest on the assumption of the financial market being inefficient to some extent and thereby creating opportunities for an acquirer to make profit⁸⁵. For example, the bidder may have private information that the firm owns valuable assets which are not reported on its balance sheet. Large premiums also may reflect either managerial mistakes or nonvalue-maximizing incentives. For example, the bidder's management may want to buy the target because expanding or diversifying the firm may generate larger salaries, more perks, and greater job security.⁸⁶

Sometimes, the incentives are overvalued. When there are many bidders or competitors for an object of highly uncertain value, a wide range bids is likely to result. The highest bidder will typically pay in excess of the expected value. The winning bidder is, therefore, "cursed" in the sense that its bid exceeds the value of what is received, so the acquiring firm loses money. Postulating strong market efficiency in all markets, the prevailing market price of the target reflects the full value of the firm. The higher valuation of the bidders, result from hubris – excessive self-confidence of the bidder. Even if there are synergies, competition between bidders is likely to result in paying too much. Still, when there is a single bidder, the potential competition of other bidders may cause the winning bidder to pay too much. And even without competition, manager sometimes commit errors of over optimism in evaluating takeover opportunities due to hubris.⁸⁷

3.2 Types of takeovers

There is no standard definition of a takeover, as each can result in a different kind of merger. Takeovers could be defined depending on the type of merger they might to form. A fundamental distinction is usually that of *horizontal* and *vertical mergers*.⁸⁸ This distinction is based on where the mergers take place in the distribution chain and their purposes. The element of relatedness is also important in defining economic categories of mergers.⁸⁹

⁸³ Weston, J. F., Chung, K. S., Siu, J. A., 1998, *Takeovers, restructuring, and corporate governance*

⁸⁴ Weston, J. F., Mitchell, M. L., Mulherin, J. H., 2002, *Takeovers, restructuring, and corporate governance*

⁸⁵ Weston, J. F., Mitchell, M. L., Mulherin, J. H., 2002, *Takeovers, restructuring, and corporate governance*

⁸⁶ Grinblatt, M., Titman, S., 2002, *Financial markets and corporate strategy*

⁸⁷ Weston, J. F., Chung, K. S., Siu, J. A., 1998, *Takeovers, restructuring, and corporate governance*

⁸⁸ Grinblatt, M., Titman, S., 2002, *Financial markets and corporate strategy*

⁸⁹ Weston, J. F., Chung, K. S., Siu, J. A., 1998, *Takeovers, restructuring, and corporate governance*



3.2.1 Horizontal and vertical mergers

A horizontal merger involves two firms operating and competing in the same kind of business activity. Thus, the acquisition in 1999 of Volvo Car Corporation by Ford represented a horizontal combination or merger. Forming a larger firm may have the benefit of economies of scale. The argument that horizontal mergers occur to realize economies of scale is, however, not sufficient to be a theory of horizontal mergers. Although these mergers would generally benefit from large-scale operation, not all small firms merge horizontally to achieve economies of scale.⁹⁰

Horizontal mergers are regulated by the government for their potential negative effect on competition. They decrease the number of firms in an industry, possibly making it easier for the industry members to collude from monopoly profits. Some believe that horizontal mergers potentially create monopoly power on the part of the combined firm, enabling it to engage in anticompetitive practices. It remains an empirical question whether horizontal mergers take place to increase the market power of the combined firm, or to seek to augment the firm's capabilities to become a more effective competitor.⁹¹

Vertical mergers occur between firms in different stages of production operation. There are many reasons why firms might want to be vertically integrated between different stages. There are technological economies such as transportation costs that could be reduced. Transactions within a firm may eliminate the costs of searching for prices, contracting, payment collection, and advertising, and may also reduce the costs of communication and of coordinating production. Planning for inventory and production may be improved due to more efficient information flow within a single firm. When assets of a firm are specialized to another firm, the latter may act opportunistically. Expropriation can be accomplished by demanding supply of good or service produced from the specialized assets at a price below its average cost. To avoid the costs of haggling that arise from expropriation attempts, the assets are owned by a single vertically integrated firm. Divergent interests of parties to a transaction can be reconciled by common ownership. The efficiency and affirmative rationale of vertical integration rests primarily on the costliness of market exchange and contracting. The argument, for instance, that uncertainty over input supply is avoided by backward integration reduces to the fact that long-term contracts are difficult to write, and police⁹²

3.2.2 Conglomerate, Strategic and Financial Takeovers

There are probably almost as many types of takeovers and mergers as there are bidders and targets. Because of this reason, investment banks find it useful to define three different categories of M&A transactions:

- Conglomerate takeovers
- Strategic takeovers
- Financial takeovers

This type of categorization of mergers is useful since it explains the various purposes of takeovers in different situations.⁹³

Conglomerate Takeover

⁹⁰ Weston, J. F., Chung, K. S., Siu, J. A., 1998, *Takeovers, restructuring, and corporate governance*

⁹¹ Weston, J. F., Chung, K. S., Siu, J. A., 1998, *Takeovers, restructuring, and corporate governance*

⁹² Weston, J. F., Chung, K. S., Siu, J. A., 1998, *Takeovers, restructuring, and corporate governance*

⁹³ Grinblatt, M., Titman, S., 2002, *Financial markets and corporate strategy*



A conglomerate takeover, involves firms with no apparent potential for operating synergies. In this sense, the conglomerate acquisition is similar to the financial acquisition described below. However, conglomerate acquisitions are more likely to be motivated by financial synergies, which lower a firm's cost of capital, thus creating value even when the operations of merged firms do not benefit from the combination. As we will discuss below, financial synergies can arise because of taxes as well as because of information and incentive problems.

Conglomerate mergers involve firms engaged in unrelated types of business activity. Among conglomerate mergers, three types have been distinguished.⁹⁴

- Product –extension mergers broaden the product lines of firms. These are mergers between firms in related business activities and may also be called concentric mergers.
- A geographic market-extension merger involves two firms whose operations have been conducted in non-overlapping geographic areas.
- Pure conglomerate mergers involve unrelated business activities. These would not qualify as either product-extension or market-extension mergers.

A fundamental economic function of investment companies is to reduce risk by diversification. Combinations of securities whose returns are not perfectly correlated reduce portfolio variance for a target rate of return. Because investment companies combine resources from many sources, their power to achieve a reduction in variance through portfolio effects is greater than that of individual investors. In addition, the management of investment companies provides professional selection from among investment alternatives.⁹⁵

Conglomerate firms differ fundamentally from investment companies in that they control the entities to which they make major financial commitments. Two important characteristics define a conglomerate firm. First, a conglomerate firm controls a range of activities in various industries that require different skills in the specific managerial functions of research, applied engineering, production, marketing, and so forth. Second, the diversification is achieved mainly by external acquisitions and mergers, not by internal development.⁹⁶

Strategic Takeovers

In many cases, strategic mergers can be viewed as horizontal mergers.⁹⁷ A strategic takeover involves operating synergies, meaning that the two firms are more profitable combined than separate. In the 1990's, strategic acquisitions became much more popular and they are now the dominant form of acquisitions. The operating synergies in a strategic acquisition may occur because the combining firms were former competitors. Alternatively, one firm may have products or talents that fit well with those of another firm.⁹⁸

Financial Takeovers

Investment bankers generally classify a takeover that includes no operating synergies as a financial takeover. In a financial takeover, the bidder usually believes that the target firm's stock is undervalued. In contrast to strategic acquisitions, financial acquisitions have declined substantially since the late 1980's. A financial acquisition is sometimes motivated by the tax gains associated with the acquisition. Alternatively, the acquirer may believe that the target

⁹⁴ Weston, J. F., Chung, K. S., Siu, J. A., 1998, *Takeovers, restructuring, and corporate governance*

⁹⁵ Weston, J. F., Chung, K. S., Siu, J. A., 1998, *Takeovers, restructuring, and corporate governance*

⁹⁶ Weston, J. F., Chung, K. S., Siu, J. A., 1998, *Takeovers, restructuring, and corporate governance*

⁹⁷ Grinblatt, M., Titman, S., 2002, *Financial markets and corporate strategy*

⁹⁸ Grinblatt, M., Titman, S., 2002, *Financial markets and corporate strategy*



firm's assets are undervalued because the stock market is ignoring important information. The most common motivation for a financial acquisition, however, is that the acquirer believes that the target firm is underperforming because it is badly managed. In most cases, a financial acquisition motivated by the acquirer's dismal view of target management is hostile. This type of acquisition is sometimes referred to as a disciplinary takeover.⁹⁹

One reason for commencing a financial takeover is to decrease the firm's cost of capital. To merge with another company is in some cases the only way to change the capital structure or cash flow and thereby decrease the cost of capital within a suitable time period.¹⁰⁰

Figure 1: Primary motives in different kinds of takeovers¹⁰¹

<i>Type of Takeover</i>	<i>Primary Motive</i>	<i>Hostile or Friendly</i>
Strategic	Operating synergies	Usually friendly
Financial	Taxes and motivation improvements	Often hostile
Conglomerate	Financial synergies, taxes and motivation improvements	Hostile or friendly

3.2.3 International takeovers

Perhaps most important when engaging in cross border takeovers are the very large cultural issues between companies in different regions – Europe, Asia and the United States and the rest of the world. The preponderance of companies is still national or regional in nature. To accommodate a global culture in a significant way represents a significant risk area to most companies. In this matter, investment banks have an important function. The acquirer needs to identify who can help them minimize the damage from an announcement of a takeover transaction. Typically, that will include considerations of employees, customers, vendors, partners and lenders in the communities in which the target company operates.¹⁰²

3.3 The hostile approach

The distinguishing factor between hostile takeovers and other arrangements is the conflict of interests between the bidder and the target company's management.¹⁰³ However, the hostility of the situation could be perceived as depending not so much on the bidding part but on the management of the target company and its responsive action.¹⁰⁴ The term "hostile takeover" could seem as negative towards the target *company* which is not correct, hostile takeovers are only hostile towards the *management* of the target companies.¹⁰⁵

Hostile takeovers can bring several positive issues. According to Manne, dean and professor emeritus of George Mason University School of Law, hostile takeovers are "*the most powerful market mechanism for displacing bad managers*".¹⁰⁶ In many cases, corporate executives are managing to benefit themselves, not the shareholders, the local community or

⁹⁹ Grinblatt, M., Titman, S., 2002, *Financial markets and corporate strategy* y

¹⁰⁰ Adri De Ridder, "Mergers and Acquisitions", October 20 2003

¹⁰¹ Grinblatt, M., Titman, S., 2002, *Financial markets and corporate strategy*, p. 697, authors' interpretation

¹⁰² Brown, M. M., 1999, *International mergers and acquisitions*

¹⁰³ Savelle, A., 1999, *Hostile takeovers and directors*

¹⁰⁴ Schwert, G. W., Hostility in Takeovers: In the Eyes of the Beholder?, *The Journal of Finance*, vol LV, No 6, December 2000, p. 2599-2640

¹⁰⁵ Savelle, A., 1999, *Hostile takeovers and directors*

¹⁰⁶ Manne, H. G., "Bring Back the Hostile Takeover", *The Wall Street Journal*, June 26 2002, p. 18



anyone else. The only way an acquirer can justify the premium he pays for his shares is to make the firm more productive. If he fails to do so, the public is not worse off: The shareholders who sold their stock have gained what the acquirer has lost. And unless they burned their money, there is no decrease in available capital for business; most sellers probably invested their proceeds in other firms. And takeovers do not have to be successful to raise share prices. In fact, the most effective way for a company to defeat a hostile bid is to improve its own operations of structure, thereby increasing its share prices. Takeovers, whether hostile or friendly, do not necessarily harm employees either, even though some post-takeover restructurings have required extensive layoffs. On the opposite, in several takeover cases the only other option would have been to shut the company down resulting in a full layoff of personal.¹⁰⁷

In a hostile takeover, the acquirer often bypasses the target's management and approaches the target company's shareholders directly with a tender offer for the purchase of their shares. A tender offer is an offer to purchase a certain number of shares at a specific price and on a specific date, generally for cash. Although a tender offer is usually associated with a hostile takeover, it is used in friendly takeovers when the target's management approves the offer before it is presented to shareholders.¹⁰⁸

Perceptions of hostility are closely linked with takeover negotiations that are far from completion. Often firms engage in confidential negotiations before there is a public announcement of a bid or an intention to bid. In some cases, the first public announcement is of a successfully completed negotiation, which would be perceived to be friendly, even if the early stage private negotiations would have seemed hostile if they had been revealed to the public. In other cases, private negotiations break down and one of the parties decides that public information about the potential bid would enhance its bargaining position. For example, bidders might choose to reveal their intentions to put stockholder pressure on target managers. Likewise, targets might reveal a takeover attempt to attract alternative bidders.¹⁰⁹

Because public announcements of takeover attempts are part of negotiating strategies, the problem of distinguishing between hostile and friendly transactions is complex. Moreover, as with any negotiation, the mood of the process can change over time as circumstances change. Many transactions that seem hostile initially result in friendly negotiated settlements. In a paper, analyzing 2.346 cases of takeovers Schwert concluded that the distinction between hostile and friendly offers is largely a reflection of negotiation strategy.¹¹⁰

From the perspective of the target firm, a hostile offer is one that it chooses to refuse publicly, often very distinct. If the goal is to avoid being acquired, this reaction should decrease the likelihood of a successful takeover. If the goal is to bargain for a better offer, this reaction should lead to a higher premium paid to target shareholders. Hard bargaining in pursuit of a higher premium could also lead to lower success rates, however, so the net of these effects must be used to judge whether target resistance benefits shareholders. One

¹⁰⁷ Brandow, D., Are Hostile Takeovers Good for the Economy?, *Business and Society Review*, Issue 63, 1987 p. 45-49

¹⁰⁸ Grinblatt, M., Titman, S., 2002, *Financial markets and corporate strategy*

¹⁰⁹ Schwert, G. W., Hostility in Takeovers: In the Eyes of the Beholder?, *The Journal of Finance*, vol LV, No 6, December 2000, p. 2599-2640

¹¹⁰ Schwert, G. W., Hostility in Takeovers: In the Eyes of the Beholder?, *The Journal of Finance*, vol LV, No 6, December 2000, p. 2599-2640



way to increase the expected premium is to initiate a multiple bidder auction. Thus, it is also interesting to know whether auctions are any more likely when bids are hostile.¹¹¹

From the bidder's perspective, a hostile offer is necessary when a private negotiation is unlikely to succeed. It could be used to put pressure on entrenched managers by making target shareholders aware of their explicit options. It could also be used to move negotiations forward in a public arena where target managers' perceptions of the value of their company to other possible bidder can be resolved through a competitive process. This is analogous to litigation that proceeds to trial instead of settling through negotiation – the public process is necessary to resolve the differences of option between the bidder and the target.¹¹²

Succeeding with a hostile takeover is in most cases a very complex accomplishment. Hostile bidders are at a disadvantage compared with friendly bidders because hostile bidders cannot in practice receive unpublished information about the target company.¹¹³ The information makes it more difficult to analyze what the target really is worth and by that what a fair bid would be. Another reason for the decrease in successful hostile takeovers is the fact that the phenomenon has gained a lot of attention which has led to the development and implementation of takeover defense mechanisms amongst many companies.¹¹⁴

3.3.1 Defenses against hostile takeovers

Not surprisingly, some incumbent managers who recognize a threat to their position posed by hostile takeovers twist corporate rules to preclude unwanted stock bids. The favoured defensive tactic is to adopt *poison pill* provisions – such as generous golden parachutes for employees and special classes of stock that become convertible into cash after a takeover – that sharply increase costs for an acquirer. As a consequence, these methods often have a negative impact on share prices.¹¹⁵

Another defensive mechanism utilized in the Swedish is to modify the length of the mandate period of the board members. The mandate period of a board member is in general one year in Sweden but this is not mandatory and the duration could be extended up till four years.¹¹⁶ The act of extending the mandate period of the board was undertaken by Pharmacia to make a takeover more difficult. However, it was not deterring enough for Pfizer who gained control over the company in September 2003.¹¹⁷

3.4 Takeover strategies

Strategies define the visions, plans, policies, and cultures of an organization over a long period. However, strategic plans do in turn affect the shorter-term decisions. Because strategic planning is concerned with the future of the organization, it follows that the ultimate responsibility resides in the top executive group.¹¹⁸

¹¹¹ Schwert, G. W., Hostility in Takeovers: In the Eyes of the Beholder?, *The Journal of Finance*, vol LV, No 6, December 2000, p. 2599-2640

¹¹² Schwert, G. W., Hostility in Takeovers: In the Eyes of the Beholder?, *The Journal of Finance*, vol LV, No 6, December 2000, p. 2599-2640

¹¹³ Savelle, A., 1999, *Hostile takeovers and directors*

¹¹⁴ Brown, M. M., 1999, *International Mergers and Acquisitions*

¹¹⁵ Brandow, D., Are Hostile Takeovers Good for the Economy?, *Business and Society Review*, Issue 63, 1987 p. 45-49

¹¹⁶ Lundén, B., 2001, *Aktiebolag*

¹¹⁷ Åkerberg, N., "Pfizer tog över allt", *Dagens Industri*, October 6 2003, p. 6-7

¹¹⁸ Weston, J. F., Mitchell, M. L., Mulherin, J. H., 2002, *Takeovers, restructuring, and corporate governance*



The goal of strategy is to guide a firm to achieve different sustainable, competitive advantages.¹¹⁹ A firm could through its competitive advantage be able to achieve value growth above the average for the economy and its product-market areas. One type of gaining competitive advantages that is rarely mentioned, even though it can largely affect the success of a firm, is by mergers and acquisitions. Acquiring capabilities and other resources could sometimes be managed through corporate growth which in turn could be generated by incorporating other firms. Therefore, M&A activities must be formulated within the framework of a company's overall strategic plan and processes.¹²⁰

General strategy goals may be formulated with respect to size, growth, stability, flexibility and technological breadth. Size objectives are established in order to use effectively the fixed factors the firm owns or buys. Growth objectives can be expressed in terms of sales, total assets, earnings per share, or the market price of the firm's stock. These are related to two valuation objectives. One is to attain a favorable price/earnings multiple for the firm's shares. A second is to increase the ratio of the market value of a firm's common stock to its book value. Stability refers to the climate in the market, for examples if it is subject to large fluctuations in number of participating actors. The meaning of flexibility is the firm's ability to operate in a wide variety of markets or market sections. Of interest in recent years is technological breadth. With the increased pace of technological changes, a firm may consider it important to possess capabilities in the rapidly advancing technologies.¹²¹

If the bidder values the control of the firm which his giving the tender offer, he might place value on the shares he acquires that exceeds their post-takeover value to target shareholders. This will occur when some of the gains from the takeover can be captured directly bidder and not by the target. For example, if the target company processes assets valuable to the acquirers other businesses – once he gains the control he can sell some of the assets of the target company to his other companies at a reduced price. When transfers of this kind could be initiated, the bidder's value of the target's shares exceeds their post-takeover value in the stock market.¹²²

Takeovers and the resulting mergers require changes in the organization of a firm. In major horizontal mergers, the acquired firm is integrated into the structure of the acquiring firm. Usually one of the goals is to achieve savings by eliminating redundant facilities, offices and employees. Sound business principles prescribe that the best facilities and the most highly qualified personnel be retained regardless of the previous company affiliation. Mergers of equals are said to protect the interest of the acquired firm. If efficiency principles are followed, no distinction should exist among mergers of equals and other kinds of mergers.¹²³

In many of the hostile takeovers, the bidder initially attempts to buy less than 100 percent of the target's shares. There are two reasons for this. First, the bidder might think that it is unnecessary to acquire all of the outstanding shares to make the changes required to improve the firm's value. Second, some shareholders may not be willing to sell their shares at any price. For example, the target's managers are unlikely to sell their shares if such a sale allows the firm to be taken over and the managers lose their jobs as a consequence.¹²⁴

¹¹⁹ Porter, M., "Competitive strategy", September 19 2003

¹²⁰ Weston, J. F., Mitchell, M. L., Mulherin, J. H., 2002, *Takeovers, restructuring, and corporate governance*

¹²¹ Weston, J. F., Mitchell, M. L., Mulherin, J. H., 2002, *Takeovers, restructuring, and corporate governance*

¹²² Grinblatt, M., Titman, S., 2002, *Financial markets and corporate strategy*

¹²³ Weston, J. F., Mitchell, M. L., Mulherin, J. H., 2002, *Takeovers, restructuring, and corporate governance*

¹²⁴ Grinblatt Grinblatt, M., Titman, S., 2002, *Financial markets and corporate strategy*

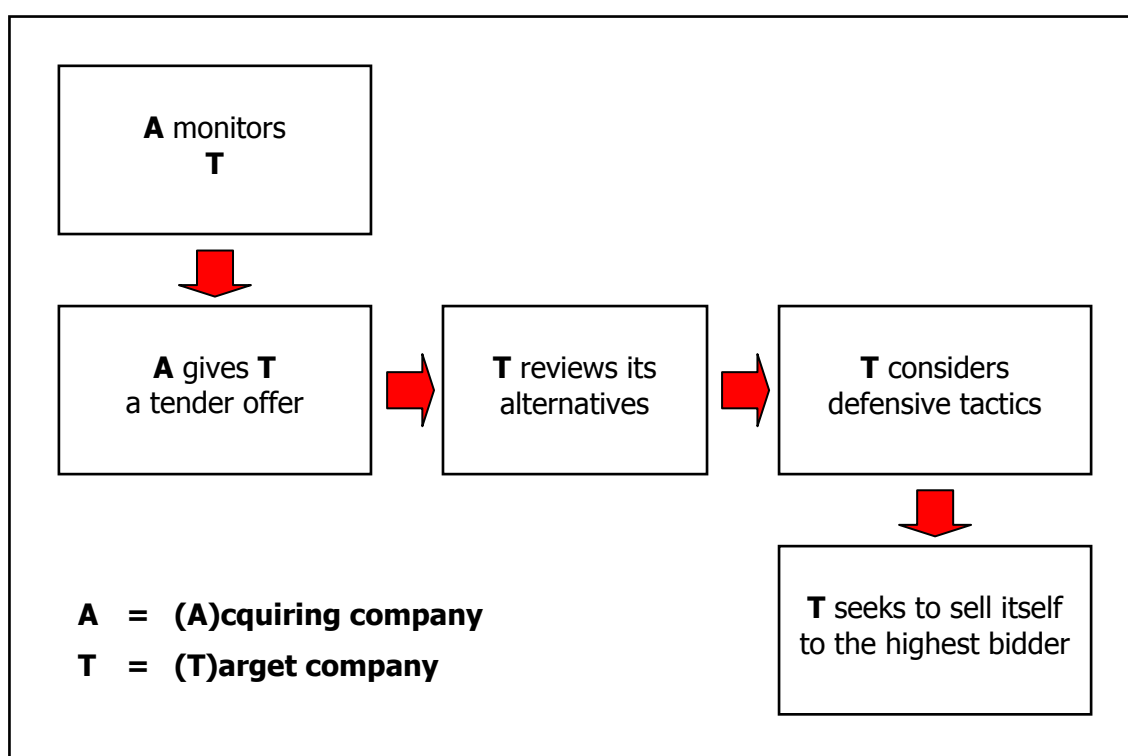


In Swedish limited companies, major decisions are discussed and approved during meetings of the board. When an issue can not be resolved through discussion, a voting is applied. For a proposal to be approved there is a demand for absolute majority of the votes. This means that more than half of the votes must be placed in favor of the alternative. This leads to the conclusion that a bidder can effectively take over a firm by accumulating over fifty percent of the target firm's shares.¹²⁵

Some decisions, however, like bringing change to the company's Articles of Association demands support by 2/3 of the votes. The different levels of support needed to approve different kinds of decisions can be altered through contract if a company finds it suitable. This is how ever quite uncommon because such a clause would easily bring conflicts into a stall.¹²⁶

The sequence of a hostile takeover could be perceived to pass through the following stages.

Figure 2; Example of a hostile takeover procedure¹²⁷



Firstly, A reviews T's vulnerability and its alternatives in a takeover situation. An important step for A is to assess T's takeover defenses. If the circumstances are perceived to be promising, A gives T a tender offer. When the offer is received by T, the company must consider various issues and interested parties. The most important decision is how to respond to the advance, either hostile or friendly. When the choice is made to counteract the tender offer, T can decide to apply different defense mechanisms. However, it often takes considerable time before the effects from these measures arise. Finally, if T considers the hostile takeover to become successful, T can look for other interested parties and

¹²⁵ Lundén, B, 2001, *Aktiebolag*

¹²⁶ Lundén, B, 2001, *Aktiebolag*

¹²⁷ Brown, M. M. & Bird, P. S., "Hostile Takeovers", *Banking Law Journal*, January 2001, Issue 118 p. 18-28



perhaps increase the premium by creating a takeover auction. Since the latter case is unwanted by A, it tries to speed up the over all process as much as possible to close the deal with the shareholders before the defensive actions are executed.¹²⁸

3.4.1 Conditional or unconditional tender offer

As mentioned, the hostile bidder usually wants to buy enough shares to gain control of the firm and then make the improvements that will elevate the firm's share price. A conditional tender offer is an offer to purchase a specific number of shares at a specific price. The offer is considered conditional because the buyer is not required to purchase any shares if the specific number of shares is not tendered. Another condition could be for the board to recommend the company's shareholders to sell – which is not a possibility in a hostile situation. The antonym is known as an unconditional tender offer which requires the bidder to purchase the tendered shares even if the quantity is insufficient to gain control of the target firm.¹²⁹

3.4.2 Secret accumulation of shares

The acquiring firm may have secretly accumulated shares on the open market and will profit on those shares when the target is taken over. Also, target shareholders may be induced to tender their shares if the bidder can convince them that they will not share in the profits that arise from the bidder's value improvements.¹³⁰

During the 1980's, many bidders secretly accumulated shares on the open market before making a takeover bid. However, nowadays regulations require purchasers to file a report to the authorities, Näringslivets Börskommitté¹³¹ in which they must make their transactions public as soon as their holdings reach a certain percentage of the total amount of outstanding shares.¹³²

In Swedish Law the aspect is regulated through law 1992:543 concerning stock exchange and clearing businesses and law 1991:980 concerning trade of financial instruments including the so called "flagging recommendations". The Swedish limited companies listed on the OM Stockholmsbörsen are obliged to a recommendation placed by the Industry Stock Exchange Committee "Näringslivets Börskommitté". The flagging recommendation instituted in the recommendation placed by the committee obligates everyone who gains possession of 5 percent or more, of a limited companies total outstanding shares, to file in a transaction announcement. This should also be done after each additional 5 percent that is eventually acquired. The purpose of the flagging recommendations is that the information about large stock possessions is perceived to be of great importance for interpreting the value of the stocks and it is also in accordance with the open accounting standards.¹³³

3.4.3 Coercive offers

In most takeovers, the bidder expects to eventually purchase all the target's outstanding shares. This could create a substantial holdout problem if there was no way to force remaining shareholders to sell their shares. In reality, however, if a sufficient number of

¹²⁸ Brown, M. M. & Bird, P. S., "Hostile Takeovers", *Banking Law Journal*, January 2001, Issue 118 p. 18-28

¹²⁹ Grinblatt, M., Titman, S., 2002, *Financial markets and corporate strategy*

¹³⁰ Grinblatt, M., Titman, S., 2002, *Financial markets and corporate strategy*

¹³¹ Blom, B., 1998, *Karnov: Svensk lagsamling med kommentarer, Uppl. 3(1998/99)*

¹³² Grinblatt, M., Titman, S., 2002, *Financial markets and corporate strategy*

¹³³ <http://www.riksdagen.se>, December 8 2003 A



target shareholders agree to merge the target firm with the bidding firm, the minority shareholders can be forced to sell their shares.¹³⁴ The 31st paragraph of the Swedish law concerning limited companies implies that a corporation holding more than 9/10 of a subsidiary has the legal right to demand to bail out the remaining stockowners.¹³⁵

In a two-tiered offer, the bidder offers a price in the initial tender offer for a specified number of shares and simultaneously announces plans to acquire the remaining shares at another price in what is known as a *follow-up merger*.¹³⁶

Two-tier offers can be coercive because they force some shareholders to tender their shares at prices they believe are inadequate. In theory, by making the second-tier offer sufficiently low, a bidder can successfully take over a firm at a price that all shareholders find unacceptable. There are, however, legal restrictions that limit how low the second-tier price can be. Although the bidder is not legally required to provide the target shareholders who do not tender with an amount that compensates them for all of the synergies brought about by the merger, the bidder is required to pay "fair value" for the target shares in the follow-up merger.¹³⁷

3.5 Valuation of takeover targets

The takeover will take place only if agreement on a price is reached. At this juncture, an in-depth analysis of the candidate's financial position and operations will reveal how it has performed in the past and allow the acquirer to estimate how it is expected to perform in the future. A thorough assessment will include identification and quantification of the perceived shared benefits that led the acquirer to approach the candidate. When launching a takeover attempt, the negotiating range is determined by quantifying the target's estimated value on a stand alone or separate basis and its combined worth to the acquirer's business. By using a variety of valuation methods, a range of values within which to negotiate can be established.¹³⁸

In any takeover situation it is important for the buyer not only to determine the value of a prospective acquisition candidate, but also to understand the goals and needs of the seller, including the seller's perception of its company's value. Such an understanding will enhance the likelihood of a successful deal, because the buyer will be more likely to price and structure a mutually acceptable offer.¹³⁹

A trend within the history of M&A is that of buyers and lenders becoming more selective. There is increasing emphasis on high quality deals that have realistic pricing. Investors are placing greater importance on *due diligence* – the intense examination of a target by an objective third party. Buyers and lenders will not be able to decide whether to pursue a takeover unless they have a full and detailed knowledge of the financial affairs of the target company. A key area for due diligence is the uncovering of undervalued, overvalued, and unrecorded assets and liabilities. Judgments are required in determining the appropriate carrying value of assets or in the measurement of certain liabilities.¹⁴⁰

In a takeover, the two forms of consideration generally available to a vendor are equity or cash. Equity typically consists of stock in the acquiring entity which may or may not be listed

¹³⁴ Grinblatt, M., Titman, S., 2002, *Financial markets and corporate strategy*

¹³⁵ <http://www.riksdagen.se>, December 8 2003 B

¹³⁶ Grinblatt, M., Titman, S., 2002, *Financial markets and corporate strategy*

¹³⁷ Grinblatt, M., Titman, S., 2002, *Financial markets and corporate strategy*

¹³⁸ Ernst & Young, 1994, *Mergers & Acquisitions*

¹³⁹ Ernst & Young, 1994, *Mergers & Acquisitions*

¹⁴⁰ Ernst & Young, 1994, *Mergers & Acquisitions*



on a stock exchange outside the country in which the acquirer is resident. Cash may be provided from the existing funds of the acquiring entity, or alternatively, it might be borrowed from one or more of a number of potential sources.¹⁴¹

Whether or not it takeover is international, surplus or idle cash is the cheapest form of finance, because its opportunity cost, that is, its yield, is lower than both the cost of borrowing and the return demanded on equity investments. The opportunity cost of using cash currently required for the operation of the business is equal to the marginal cost of borrowing; it is still cheaper than the cost of equity.¹⁴²

Research indicates that the typical target firm in a hostile takeover has the following characteristics;¹⁴³

- It has underperformed other stocks in its industry and the overall market in terms of returns to its stock holders in the years preceding the takeover.
- It has been less profitable than firms in its industry in the years preceding the takeover.
- It has a much lower stock holding by insiders than do firms in its peer groups.

When valuing an entire company, and not only the equity, there are two commonly used methods. One method is to discount the cumulated cash flows to all claim holders in the firm by the weighted average cost of capital, the cost of capital approach. The other method is by adding the marginal cost of debt on value to the unlevered firm value, the adjusted present value (APV) approach.¹⁴⁴

Choosing a cash flow to discount is in many ways a crucial moment in the valuation process because it has a major impact on the outcome. With consistent assumptions about growth and leverage, one should get the same value for equity using the firm approach, where the firm is valued and the outstanding debt is subtracted, and the equity approach; where the equity is valued directly. For firms with stable leverage, the most convenient model may be chosen. However, for firms with unstable leverage, where the debt to equity ratio is likely to change during the period of valuation, the firm valuation is much simpler to use. The reason is that it does not require cash flow projections from interest and principal payments and is much less sensitive to errors in estimating leverage changes.¹⁴⁵

The calculation of the cost of capital requires an estimate of the debt to equity ratio, but the cost of capital itself does not change as much as a consequence of changing leverage as does the cash flow to equity. If one prefers to work with assumptions about monetary debt rather than debt to equity ratios, the adjusted present value formula approach could be applied.¹⁴⁶

3.5.1 Free Cash Flow to Firm

The free cash flow to firm (FCFF) is the sum of the cash flows to all claim holders in the firm, including stockholders, bondholders, and preferred stockholders. The simplest way to getting

¹⁴¹ Ernst & Young, 1994, *Mergers & Acquisitions*

¹⁴² Ernst & Young, 1994, *Mergers & Acquisitions*

¹⁴³ Damodaran, A., 2002, *Investment valuation*

¹⁴⁴ Damodaran, A., 2002, *Investment valuation*

¹⁴⁵ Damodaran, A., 2002, *Investment valuation*

¹⁴⁶ Damodaran, A., 2002, *Investment valuation*



the free cash flow is to begin with the earnings before interest and tax (EBIT), net out taxes and reinvestment needs, and arrive at an estimate of the free cash flow to the firm:

$$FCFF = EBIT(1 - \text{Tax rate}) + \text{Depreciation} - \text{Capital Expenditure} - \Delta \text{Working Capital}$$

Since this cash flow is prior to debt payments it is often referred to as an unleveled cash flow. This free cash flow does not incorporate any tax benefits due to interest payments. The use of after tax cost of debt in the cost of capital already considers this benefit, and including it in the cash flows would double count it.¹⁴⁷

A firm that is growing at a rate that it can sustain in perpetuity – a stable growth rate – can be valued using a stable growth model; the FCFF model uses the following equation:¹⁴⁸

$$\text{Vale of firm} = \frac{FCFF_1}{(WACC - g_n)}$$

Where $FCFF_1$ = Expected FCFF next year

WACC = Weighted average cost of capital

g_n = Growth rate in the FCFF forever

The value of the firms equity is calculated by following equation:¹⁴⁹

$$\text{Value of equity} = \text{Value of operating assets} + \text{Cash and marketable securities} - \text{Debt}$$

Normalized earnings

When earnings are negative or abnormal, it is sometimes possible to replace current earning with a normalized value, estimated by looking at the company's history or industry averages, and value the firm based on these normalized earning. The way to deal with negative earnings will depend on why the firm has negative earnings in the first place. When valuating companies with firm specific, temporary problems, one could apply the operating margin that the firm earned in prior years to the current year's revenues and estimate an operating income to use in the valuation.¹⁵⁰

When using normalized earnings, the free cash flow to firm is calculated in a different way than the basic formula implies;

¹⁴⁷ Damodaran, A., 2002, *Investment valuation*

¹⁴⁸ Damodaran, A., 2002, *Investment valuation*

¹⁴⁹ Damodaran, A., 2002, *Investment valuation*

¹⁵⁰ Damodaran, A., 2002, *Investment valuation*



$$FCFF = EBIT(1 + g)(1 - \text{Tax rate})(1 - \text{Reinvestment rate})$$

The Weighted Average Cost of Capital

The WACC method computes the unleveled cash flows and accounts for the debt tax subsidy by adjusting the discount rate that is applied to the unleveled cash flows. This adjusted discount rate is the weighted average cost of capital. Mathematically this can be expressed as;¹⁵¹

$$WACC = W_e R_e + W_d (1 - T_c) R_d$$

where

- $W_e = E/(D+E) =$ equity over financing
- $W_d = D/(D+E) =$ debt over financing
- $T_c =$ marginal corporate tax rate if interest is fully tax deductible
- $R_e =$ the expected return on equity to investors
- $R_d =$ the expected return on debt to investors

The cost of Equity

To find the cost of equity we have use the capital asset pricing model, CAPM;¹⁵²

$$R_e = R_f + \beta(R_m - R_f)$$

Where

- $R_e =$ Expected return on an equity investment
- $R_f =$ Risk free rate
- $R_m =$ Market rate, for all equity

According to the theoretical view the market portfolio should consist of the value of all assets on all markets. The return on the market portfolio should therefore be a weighted average of all assets return. In statistical analyzes of the stock market, a stock market index is often used as an approximate for the market portfolio.¹⁵³

The equity betas generally used in the CAPM formula are betas that are estimated from historical return data. The expected rate of return of a firm's equity obtained with this method is the relevant cost of equity financing, whether or not there are tax advantages to debt financing.¹⁵⁴ When valuating a firm is common to use a forward looking beta based on

¹⁵¹ Grinblatt, M., Titman, S., 2002, *Financial markets and corporate strategy*

¹⁵² Damodaran, A., 2002, *Investment valuation*

¹⁵³ De Ridder, A., 1988, *Börsstopp och kursutveckling på Stockholmsbörsen*

¹⁵⁴ Grinblatt, M., Titman, S., 2002, *Financial markets and corporate strategy*



the regression beta but with the future outlook taken in to the calculation of the firm's beta¹⁵⁵.

To calculate the firms expected free cash flow next year, it is necessary to compute the firms return on the capital invested in the firm (ROC) and the reinvestment rate. Return on capital relates the operating income to the capital invested in the firm, where capital is defined as the sum of book value of debt.¹⁵⁶

$$\text{Return on capital ROC} = \text{EBIT}(1 - t) / \text{Book value of capital}$$

The reinvestment rate used to estimate free cash flows to the firm should be consistent with the stable growth rate. The reinvestment rate is calculated using the following formula:¹⁵⁷

$$\text{Reinvestment rate} = g / \text{ROC}$$

Consequently, the firm's expected growth rate, g , can be calculated by $\text{ROC} * \text{reinvestment rate}$

As already stated, the free cash flow valuation of a firm is only one of two frequently used methods. The other is a relative valuation and it will be described in the following section.

3.5.2 Relative valuation

Most equity research and many takeover valuations are based on multiples. The relative valuation is a commonly used method because of several reasons. Firstly, a valuation based on a multiple and comparable firms can be completed with far fewer explicit assumptions and far more quickly than a discounted cash flow valuation. Secondly, a relative valuation is simpler to understand and easier to present to clients and customers than cash flow valuation. Finally, a relative valuation is much more likely to reflect the current mood of the market, since it is an attempt to measure relative and not intrinsic value. Relative valuations will generally yield values that are closer to the market price than discounted cash flow valuations. To compare the values of similar firms in the market, the values need to be standardized in some way.¹⁵⁸

The downside with relative valuation is that the easiness that a relative valuation can be put together can also result in inconsistent estimates of value where key variables such as risk, growth, or cash flow potential are ignored. Second, the fact that the multiples reflect the market mood also imply that using relative valuation to estimate the value of an asset can result in values that are too high when the market is overvaluing comparable firms, or too low when it is undervaluing these firms. Third, while there is scope for bias in any type of valuation, the lack of transparency regarding the underlying assumptions in relative valuations makes them particularly vulnerable to manipulation.¹⁵⁹

¹⁵⁵ Irfeldt, J., Swedbank, November 25 2003

¹⁵⁶ Damodaran, A., 2002, *Investment valuation*

¹⁵⁷ Damodaran, A., 2002, *Investment valuation*

¹⁵⁸ Damodaran, A., 2002, *Investment valuation*

¹⁵⁹ Damodaran, A., 2002, *Investment valuation*



4 Empiric study

This chapter is based on several interviews conducted by the authors during their work. The purpose of the interviews is to generate a picture of how hostile takeovers are perceived by professionals, both in general and in the case of the Swedish market and Ericsson. The interviews are rendered without any additions made by the authors. The persons who were interviewed are initially given a short description which explains why they are suitable to consult. Since the interviewed individuals have different areas of expertise and experience, their contribution to each section in this chapter might vary to some extent.

The authors chose to focus their main interviews on the following individuals;

- Mr Andreas Ekström, Capital Markets, Telecom stock analyst specialized in telecom operators.
Svenska Handelsbanken, Stockholm
- Mr Gary Pinkham, Vice President of Investor Relations department.
Ericsson, New York.
- Mr Jacob Spens, M&A department, expertise in M&A within several markets.
Enskilda Securities AB, Stockholm.
- Mr Peter Rabe, Director of M&A department, expertise in M&A within several markets.
Enskilda Securities AB, Stockholm.
- Mr Petri Arjama, Capital Markets, Telecom stock analyst specialized in telecom producers.
Svenska Handelsbanken, Helsinki.
- Mr Ulf Aspenberg, M&A department, expertise in M&A within several markets.
Svenska Handelsbanken, Stockholm.
Member of the Swedish Stock Market Committee.

Enskilda Securities AB along with Carnegie are the two largest investment banks in Sweden with many years of experience in the field of M&A.¹⁶⁰

4.1 The hostile approach

As a starting point for this discussion, the meaning of hostility in takeover situations needs to be clarified. As for many issues in this chapter, the opinions of the respondents and current theory might differ quite a lot.

If the share holders own a share with a price of SEK 100 in the stock exchange, and they receive an offer to sell their shares for SEK 130, is that hostile? No, of course it is not. The word hostile comes from situations where the management neglects the share holders and only cares for its own interests. The board and management do not like these kinds of offers since they often bring a displacement of the incumbent executive level of the target company. That will of course mean that they will be prohibited to implement their future plans and ideas in the company. An offer being hostile when it is not welcomed by the management has been the dominating perception for many years.¹⁶¹

¹⁶⁰ Rabe, P., Enskilda Securities AB

¹⁶¹ Aspenberg, U., Svenska Handelsbanken



According to Mr Rabe, when the approach is hostile, it means not having the support of the management resulting in the stock owner not getting a recommendation to sell.¹⁶²

Suppose that the management would receive an offer of, for example, SEK 30 above the current share price to which they respond negatively and start to counteract. This scenario would probably result in upsetting their share holders. They could perceive themselves to be robbed of SEK 30 a share. This is a share holder value mindset which has gained a lot of influence during the last couple of years. The core concept is that the board and the CEO are not actually owning the company, the share holders are and it is up to them to make the decision of whether to accept an offer or not. Then there will, per definition, be fewer hostile takeovers – they might secretly be hostile since the board finds it miserable to be taken over but all they can do is to keep up their good appearance in the vicious game. And then it will not be perceived as hostile.¹⁶³

Mr Aspenberg claims that hostile takeovers in general do not bring any positive issues. It is always much better to do it the friendly way. The negative reputation of hostile takeovers is not unfair. It comes from the management not considering the shareholders perspective but only the perspective of itself and therefore considers the offer to be hostile. Nowadays, the apprehension has changed and it is more driven by share holder value.¹⁶⁴

Mr Rabe does not consider there to be any downsides to hostile takeovers. It does not have to be hostile towards the stock owners and they are the ones who own the company, it is their money. To them, a hostile takeover attempt might pose a great offer of getting a premium right away instead of having to wait, perhaps, at least a couple years before the stock would climb to a comparable level. The owners get well paid right away and have the possibility to invest the money elsewhere for further value gains. Since there is no hostility towards the owners there is nothing fundamentally that would be negative about hostile takeovers.¹⁶⁵

4.1.1 Accomplishment difficulties

When a hostile bid is placed there are no “pre commitments” from the owners – there is no agreement about selling the shares prior to the announcement of the bid. This makes the situation more trouble some for the acquirer.¹⁶⁶

The fact of hostile bidders not getting access to all relevant information of the target company is another reason for hostile takeovers being quite rare. It has become more and more common that acquirers want to perform due diligence, which is to gain access to information, budgets, essential contracts et cetera before placing the bid. Of course, this requires approval of the board which will not be received in a hostile situation, resulting in largely increasing the bidder’s risk. If the bidder is dependent on external financing by borrowing cash, the takeover will become almost impossible since banks require a due diligence. In a hostile takeover, you have to be able to finance the whole transaction by yourself and that is another reason for it being a rare occurrence.¹⁶⁷

The hostile bidder really is in deep water if a stock offer is being used which of course is pretty uncommon in hostile situations – but it does happen. When a stock offer is given, the character of the takeover becomes more of a merger. Even though the original stockowners

¹⁶² Rabe, P., Enskilda Securities AB

¹⁶³ Aspenberg, U., Svenska Handelsbanken

¹⁶⁴ Aspenberg, U., Svenska Handelsbanken

¹⁶⁵ Rabe, P., Enskilda Securities AB

¹⁶⁶ Rabe, P., Enskilda Securities AB

¹⁶⁷ Rabe, P., Enskilda Securities AB



are given a premium they become owners in the new company which gives the bidder a weakness right from the start. It also makes the offer more complicated since the bid needs a substantial description which cash bids do not need. There is a big difference of actual cash and shares in a future company which could be constructed in a tremendous amount of ways.¹⁶⁸

When an offer is given, the board must make a statement towards the shareholders and the management concerning what currency is being used. If it is cash then there is no problem but when share in another company are being used it could be perceived as overvalued and blown-up which in turn could be a reason for opposing the offer.¹⁶⁹

The industrial logic and maintaining the organizational synergies post merger may be at risk when hostile takeover is carried out.¹⁷⁰

One of the negative aspects of hostile takeovers is the risk of having the whole organization turned against you. It might also be more difficult to reach the 90 percent that are required for a coercive stock trade. If the board advises against the offer some share holders might not want to tender their shares since such an advice often is based on a solid reason.¹⁷¹

If it is a knowledge based company in contrast to a manufacturing company, you are very dependent of key employees and the members of the management etc. It is important to keep these people within the company since they consist its value, you do not want to pay for something that might walk out the door the next day. The practical procedures of a hostile takeover are easier to carry out when the target firms for example are work shops, timbering companies and such where it does not matter as much who the members of the board are. If the existing management has a problem with the changes that the acquirer intends to implement, they are simply removed.¹⁷²

When buying a real estate firm it does not matter so much if the employees becomes upset and abandons ship since the real estate remains within the firm. The same often applies when taking over financial companies. However, everybody is in fact much dependent on keeping the employees motivated, dedicated and acting in a proper way. In some very particular cases where the target firms are extremely badly managed the management should be fired along with some parts of the incumbent personal. However, it might be wise to enter in a smooth way, as a friend, and after a while start making changes. The level of friendliness could of course be discussed but you cannot afford having everyone turned against you.¹⁷³

4.1.2 Reasons for accomplishments and benefits

Sometimes there is however the need for proceeding without the consent of the board and management. Perhaps, the premium included in the offer is too small. The larger the premium being offered the more difficult it becomes for the management and board to oppose it.¹⁷⁴

¹⁶⁸ Spens, J., Enskilda Securities AB

¹⁶⁹ Aspenberg, U., Svenska Handelsbanken

¹⁷⁰ Arjama, P., Svenska Handelsbanken

¹⁷¹ Aspenberg, U., Svenska Handelsbanken

¹⁷² Rabe, P., Enskilda Securities AB

¹⁷³ Aspenberg, U., Svenska Handelsbanken

¹⁷⁴ Aspenberg, U., Svenska Handelsbanken



Most of the time, a hostile bid is bad news to the management of a company meanwhile it might bring a good business opportunity towards the stock owners. It does not have to be hostile towards them since they might get well paid for their shares.¹⁷⁵

The offer is most likely to be more beneficial for shareholders in hostile takeovers compared with friendly.¹⁷⁶

Hostile takeovers are good since they put pressure on the management and the board of companies. For example, if an offer is made of \$ 9 per share when the actual rate is \$ 6, the board takes a big risk if it chooses not to recommend the share holders to tender their shares. If the stock price rises to the vicinity of \$ 9 after some time, they have made a proper decision but situations like this can never be taken for granted. And, if the stock price remains the same or decreases – then what value has the board generated to its share holders? The pressure that a hostile offer puts on the management and board makes their task of value creating clear; this is after all what they are obliged to do.¹⁷⁷

This is a part of the game when one gets involved in a real hostile takeover. The board is not cooperative and perhaps not evens the head stock holder who is controlling thirty percent and blocks the whole deal. If the acquirer, however, succeeds to gain twenty percent and then places a very lucrative offer on the market, the management and the head owner will experience enormous pressure. The board is obliged to look after the interest of all the stock owners, not only the head owner which puts the board members in a dilemma. How should the board act, what should it recommend its share holders, how would such a recommendation be motivated et cetera. It is a part of the game for the bidder to, in public, put pressure since it would not only affect the target company in an economic way but also its reputation and relations with different parties.¹⁷⁸

However, there is the case when, for various reasons, both the stock owners and the board perceives the bid to be inconsistent with the future value of the company. Perhaps the value of the stock is unusually low, there have been substantial investments in facilities which in time will produce good return. In this case, the management must try and convince its owners not to accept the bid and to explain that it will be more profitable to remain as owners. Still, the pressure created by a hostile offer might have positive effects on the motivation of target company's managements.¹⁷⁹

Gains in takeovers might be apprehended when the owner perceives that the target company are not correctly valued by the stock market and sees a potential in acquiring it, sometimes for immediate resale as a whole or section by section. Sometimes, they need to be conducted under hostile circumstances to achieve these objectives.¹⁸⁰

4.2 Hostile takeovers in Sweden

"Hostile takeovers are quite unusual and especially so in Sweden".¹⁸¹

When a foreign investor is planning a takeover in Sweden he starts by consulting investment banks and advisors in his own country. They, however, rarely knows all the necessary details

¹⁷⁵ Rabe, P., Enskilda Securities AB

¹⁷⁶ Arjama, P., Svenska Handelsbanken

¹⁷⁷ Spens, J., Enskilda Securities AB

¹⁷⁸ Rabe, P., Enskilda Securities AB

¹⁷⁹ Rabe, P., Enskilda Securities AB

¹⁸⁰ Spence, J., Enskilda Securities AB

¹⁸¹ Aspenberg, U., Svenska Handelsbanken



about the Swedish environment so they contact investment banks and a lot of times also one of the large lawyers offices to clear out the legal circumstances. Most of the time, foreign investors contact a Swedish investment bank just before making their official statement, which means that we (investment banks) usually enter the scene in a pretty late stage. They need a Swedish bank with an office network that knows the shareholders and which can carry out the process in Sweden. If there are dominating shareholders in the target company they have probably had an initial previous discussion about what standpoint to take.¹⁸²

Because of the Swedish tradition of owning constellation, the concentration of ownership is much greater in Swedish companies compared to the ones on the US market, for example. This has led to a moderate amount of hostile takeover attempts aimed at Swedish limited companies over the years. The occurrence of hostile takeovers is more frequent on other markets with more of an open ownership structure. In addition to the ownership structure, there is the conventional system of having A- and B-shares with different voting values which makes a hostile takeover even more difficult. Ericsson is a good example of the latter case.¹⁸³

If the ownership of the target company is constellated by a few large owners, the chance of success is very small if none of them is cooperative. When the ownership is more like that of the Anglo-Saxon world, where the ownership to a larger extent is consisting of institutions, funds and pension companies holding only a few percent each, it is much easier to carry out a hostile takeover.¹⁸⁴

A pension fund brings another kind of ownership, it involves another kind of owner – their ambition is to maximize return. In Sweden, however, many of the large companies listed on the stock exchange are controlled by families and they could have a different agenda. Politics and other values are considered in opposite of only pursuing maximizing of return.¹⁸⁵

There are some important differences when launching a hostile takeover attempt in Sweden but the share holder value mindset has become quite established here which means that there is hardly any board in Sweden that would counteract an offer. Some offers might be perceived as being too low and the board apprehend the company to be worth more. If that is the case, however, the board has the burden of proof for its standpoint. If they can prove this, they have properly satisfied the share holders. Some bidders, especially foreigners, approaches the board with an offer based on the prerequisite of the boards consensus through a recommendation to the shareholders. This is called a negotiated offer and has the purpose of securing a positive position from the target company and thereby avoiding conflict. Through negotiated offers, the chance increases of conducting the offer in a friendly way and also reaching the critical 90 percent limit. When the critical limit is reached, the chance increase of a takeover without legal complications, departures and aggressiveness. This is one of the reasons why the number of hostile takeovers is very low.¹⁸⁶

The basic steps for taking over a Swedish company is making an offer in accordance with the Näringslivets Börskommite's take over regulation and if 90 percent of the outstanding shares are apprehended, the rest can be acquired coercively. A 100 percent ownership of the target company's outstanding shares is as good as always the ambition. Without the 100 percent you can not apply the changes that are planned, you can not merge the target with your own local business since there is a minority left in the company. There are exceptions but

¹⁸² Aspenberg, U., Svenska Handelsbanken

¹⁸³ Spens, J., Enskilda Securities AB

¹⁸⁴ Rabe, P., Enskilda Securities AB

¹⁸⁵ Spens, J., Enskilda Securities AB

¹⁸⁶ Aspenberg, U., Svenska Handelsbanken



the main rule is to buy all of the shares to be able to make decisions without the concern of any minorities.¹⁸⁷

The difference between the Swedish takeover code and that of other countries decreases for each time that the rules are audited by the Swedish authorities or when a difficult case turns up. In these cases, the first question is always "How is it regulated in England?" and the second question is "How is it regulated in New York?". So we do take a lot of impression from abroad and the European Council is working for harmonizing the different legislations. The process is striving towards unity in the whole western world on this issue. But there are quite a few differences concerning the details, for example coercive redemption that is a possibility in most countries but conducted in different ways.

4.2.1 Movements on the telecom market

The telecom sector has a great intensity of events. There will be more consolidation since several of the operators financial status has experienced large amounts of stress. This mainly applies to recent created companies like Song Networks and Utfors. Many of them has vanished, there has been a thin out among the market players due to bad finances. Merging between larger and more established companies, like Telia and Sonera, are the results of attempts to create synergies and there will probably be more like these.¹⁸⁸

When there is an increase of actors on a market there is absolutely a chance of an increase in consolidation activity. Supposed that there are synergies to extract, it differs some between different markets. When a lot of actors have the same area of expertise and the market size stays consistent, consolidation is the path to chose. On one hand, there might be gains in expanding the size of the firm, there might also be gains in being able to offer complementary products and to enter other geographical markets. All of those objectives can be achieved through consolidation, in fact, sometimes it is the only way to accomplish this within a reasonable time frame.¹⁸⁹

Each industry that is exposed to drastic changes is also affected by restructuring within the corporate sector. One has to adjust to the new circumstances and that is done by joining up with others, by acquiring or selling of business sections like a division that is focused on a business that is too small. Selling and then using the money to develop the other parts might in that situation be a good idea. If 3G brings such restructuring and new conditions, it should also lead to this kind of consolidation.¹⁹⁰

Mr Pinkham, at Ericsson, does not think 3G will changes the competition much because the barriers to enter the market are high. You might see a couple of new entrants but also a couple of exits as well. So I think that the total amount of players remains the same. With three or four players controlling more than 80 percent of the market. The top players; Ericsson, Nokia and Siemens – that is the top three. Then, Nortel might secure a position where they might be considered to be one of the top players. Then you have a handful of others, some of the Japanese and Chinese suppliers. But Motorola has fallen out of the market here, they have not captured anything. Alcatel has a relatively small position.¹⁹¹

There will probably not be a tremendous amount of new entrants on the telecom market because of 3G. The only new really big global actor would be 3, owned by Hutchinson

¹⁸⁷ Aspenberg, U., Svenska Handelsbanken

¹⁸⁸ Ekström, A., Svenska Handelsbanken

¹⁸⁹ Spens, J., Enskilda Securities AB

¹⁹⁰ Aspenberg, U., Svenska Handelsbanken

¹⁹¹ Pinkham, G., Ericsson



Whampoa. Their market includes for instance Australia, UK, Italy and Sweden. There are however many Asian suppliers like Samsung who wants to enter the market.¹⁹²

One could say that in a weak financial climate there should be more M&A activity since it becomes easier to buy. At the same time, in difficult financial times a lot of actors feel a bit awkward about making large deals. When the prices increase and the climate becomes stronger, the business cycle tends to be rising making the investors more courageous which results in more deals. The psychology in this area is note to be underestimated. Sometimes good deals are not closed only because one of the parts considers it to be uncertain times.¹⁹³

4.2.2 Threats towards Ericsson

Ericsson is unique in two aspects. It is a very much international company with a long heritage and many local markets so while it is a global company with a strong global presence. And it has had that for a long time. The other is the technological competence, especially around network concepts as well as vocal communications.¹⁹⁴

There are tendencies that operators are trying to enter the producing market. Most of all, there is a great battle between Nokia and Vodafone where both parties are trying to gain as much power as possible. Nokia does not want Vodafone to become too powerful and vice versa. A good example is the branding of the mobile phones, where Vodafone strives at creating a Vodafone Live telephone. The ambition is for the customer not to be buying a Nokia but Vodafone telephone. Mr Ekström, at Svenska Handelsbanken, finds this battle very interesting because it could result in the operator becoming closest to the customer. *"As today, you might pick a Nokia phone and be quite indifferent it terms of what operator you have since they still offer the same quality and kind of service. The operators are trying to turn this around putting themselves closest to the customer. In this battle, Nokia is fighting with all their accessible means to defend the company's position in the value chain. The dynamics of the situation is interesting indeed."*¹⁹⁵

Vodafone is not alone; there are several operators that chare the ambition especially abroad. In England for example, Orange are putting a lot of effort in their own phones. In Sweden, 3 do the same and it will become more obvious once they get established. In a lot of cases, both the logotypes of the operator and the producer are visible on the mobile phones.¹⁹⁶

Except for the operators, Microsoft might be an interested party. But their ambition focuses more on the software; they are probably not really interested in producing the actual product but instead the contents of it, the services and so forth.¹⁹⁷

Nokia does probably have sufficient funds to carry out the takeover but such an act would probably not be given approval by the authority of competition.¹⁹⁸

There have not been any tender offers as far as Mr Pinkham knows.

Concerning a change in voting power of the different classes of shares, Mr Aspenberg does not consider it to be of major importance. He believes that the acquirer must accumulate more than ninety percent to be able to become singe owners of the company. *"Whether the*

¹⁹² Ekström, A., Svenska Handelsbanken

¹⁹³ Aspenberg, U., Svenska Handelsbanken

¹⁹⁴ Pinkham, G., Ericsson

¹⁹⁵ Ekström, A., Svenska Handelsbanken

¹⁹⁶ Ekström, A., Svenska Handelsbanken

¹⁹⁷ Ekström, A., Svenska Handelsbanken

¹⁹⁸ Aspenberg, U., Svenska Handelsbanken



voting value of A shares are a thousand or ten times that of a B share, the acquirer still must negotiate with Investor and Industrivärden before such a deal could be closed."¹⁹⁹

Sony Ericsson does co-branding already today, you can find in your market the Vodafone logo, our special Vodafone snap-on cover on the phones. And if it is a software interface, we have a Vodafone Live interface so it is more a co-branding approach. So it does not affect the value creating. They probably want to have their own unique designs strictly for Vodafone and they contract different manufacturers to do that. But then again, the consumer will buy the device they like since it is a consumer market.²⁰⁰

If someone would offer SEK 20 a share there is most likely also someone who would offer SEK 22. In principle, you are supposed to think in these terms. First, the management must consider if the acquirer is likely to get a takeover approval. If the acquirer will become to dominating if he also own Ericsson, then the situation is without prospects. The Competition Authority will turn down the deal. But if it is given a green light and someone offers SEK 20 in cash per share, how could Investor and Industrivärden explain to their share holders that they turned down a very lucrative offer? To do this, one must perceive today's stock rating to be deeply underestimated and suspect it to rise within a near future to a level of SEK 25-30. But such a daring statement brings a pretty tough burden of proof.²⁰¹

The buyer could also be using shares of his own company as a currency with a rate of SEK 20. This could lead to the discussion about the offered stock being overvalued and not representing a durable value. But to make such a claim you have to be able to prove your suggestions. That is why almost all boards contact an investment bank to assist before they make their official statement. It is important, whether one advises against or recommends. If criticism is received it might be good to be supported by an investment bank who has given its suggestion.²⁰²

If an offer came up, there are two aspects to consider. Firstly, the management has to determine if this makes sense, from a strategic perspective. Then the share holders must decide from a financial perspective if it makes sense to them. When you get a generous offer you have to make it known to all interested parties.²⁰³

Ericsson has no evident or official poison pills. However, in the market these days, one reason to have a strong cash position is for defensive purposes and if opportunities comes up on the market. *"We have the A- and B-share structure and that's a defensive mechanism in a way because the voting power of different shares. But otherwise, there are no defense mechanisms – other than having a strong cash position."*²⁰⁴

There are no absolute reasons for a takeover of Ericsson not happening but it depends on who the buyer is. If the buyer states that he intends to let research and development to remain in Sweden, not cutting the amount of domestic employees et cetera. These things are however always stated but there is little reason in buying only to bring closure. Ten years ago, a takeover would have been impossible because of restricted shares not allowing foreigners to buy. But the issue is not influenced so much by politics anymore. However, since Ericsson also is a supplier in the military industry, a good relationship with the Swedish government is required. If it is not, the government could withdraw the special permit that is required for such business. Formerly, the authorities and the politicians were the largest

¹⁹⁹ Aspenberg, U., Svenska Handelsbanken

²⁰⁰ Pinkham, G., Ericsson

²⁰¹ Aspenberg, U., Svenska Handelsbanken

²⁰² Aspenberg, U., Svenska Handelsbanken

²⁰³ Pinkham, G., Ericsson

²⁰⁴ Pinkham, G., Ericsson



problem; now they can almost be ignored. Instead, respect must given to the competition authority which issues the takeover permissions.²⁰⁵

I don't know the telecom market that well but I think that the risk of Ericsson being taken over is probably quite faint, Mr Aspenberg states. In ten years time, you never know, but not in the immediate future. And when acquiring Ericsson, you only get fifty percent of Sony Ericsson.²⁰⁶

4.2.3 Valuation of Ericsson

An acquirer starts by collecting official material concerning the potential target firm. If the acquirer is a foreigner and in the same line of business he is most likely to already possess a lot of fundamental knowledge concerning the industry. Then the target must be valued to get a picture what kind of synergies that could be achieved in a takeover. This is always done most easily by concentrating on the expenses – to cut double expenses for example. Perhaps the acquirer might become larger in the purchase department which could help by reducing the prices by a few percentages. Then you sometimes consider if there are synergies to apprehend on incomes, perhaps by increasing sales due to a larger market share. This is however hard to predict and to quantify. Nowadays, however, it is almost custom to, prior to placing a bid on a Swedish company, conduct a due diligence. This means that the target company lets their records be audited, to some extent, and that some of the executives will be available for questioning.²⁰⁷

The custom of conducting due diligence is quite new but it is already widely accepted, especially when foreigners are interested in takeovers. They conduct it and then they contact the board with an offer, usually with a prerequisite of a recommendation towards the share holders, a so called recommended offer. The due diligence is mostly also a part of the prerequisite. In this case, the board most discuss if a negative response to the request for due diligence would mean robbing the share holders of the takeover premium. In other words, they are likely to comply with this request. Further more; it must be considered whether it could cause damage to the company to let another party, which sometimes is a competitor, gain access to its records, customer structure and so forth. In that case, the due diligence can be limited so that no intelligence will be exposed that might damage the company in case no other bid would emerge. This issue is also quite new but also very important, the lawyers offices could in these cases provide safety to the target firm by constructing contracts of secrecy and other legal documents.²⁰⁸

Mr Ericsson says that a company like Ericsson is difficult to value since it is having a hard time making profit on its products. *“If you do not expect Ericsson to ever make profit, then Ericsson is not a going concern and will receive a negative value or a cutting-up value to represent what would be gained if the different parts were sold out. But the opinion of the market is that the business cycle will turn, that the telecom operators will gain strength through better finances and start investing again. One of the major drawbacks for Ericsson is that the stock market has put high demands on the operators to stop investing in large extents. They have redrawn their investments and refrained from placing orders to Ericsson for example. The finances of the operators have shown to improve which increases the hopes of Ericsson receiving more orders. The view of Ericsson today is that they will make*

²⁰⁵ Aspenberg, U., Svenska Handelsbanken

²⁰⁶ Aspenberg, U., Svenska Handelsbanken

²⁰⁷ Aspenberg, U., Svenska Handelsbanken

²⁰⁸ Aspenberg, U., Svenska Handelsbanken



*money in the future and with quite satisfying margins. And the main reason is the improved finances of the operators.*²⁰⁹

*“The rating probably has much to do with market scientism if anything because nowadays, we have quite a strong balance sheet. And last year, we (read: Ericsson) raised additional capital using equity in a rights offering as appose to borrowing more money. This has given us quite a strong cash position and a strong balance sheet to take away some of the risk relative to the dept. That was part of the strategy, to at leas maintain where we were. If we can demonstrate that the company becomes predictable and we have a strong balance sheet, the credit rating will improve over time. All these factors together; predictable performance, strong balance sheet, improving credit rating – that will reduce the volatility to a certain extent on the share price. Then the beta begins to be less. These changes could take as much as two years to realize as from now, it probably might take three years. It takes time. As for now, we do not have a defined goal for the beta value of where we would like it to be.”*²¹⁰

The general methods being used in the valuation process is calculations of the present value of future cash flows in addition to examining peer groups, what similar companies there are, what is the P/E rating, and what the different business rations are. The most important thing is to compare them to other companies.²¹¹

²⁰⁹ Ekström, A., Svenska Handelsbanken

²¹⁰ Pinkham, G., Ericsson

²¹¹ Pinkham, G., Ericsson



5 Research findings and interpretation

In the previous chapter, the results of our interviews were presented. The purpose of the study was to build a foundation for an interpretation and to provide the reader with a picture of the nature of hostile takeovers and how they are affected by the circumstances in the Swedish environment. This chapter aims at concluding the problem issue to put the theoretical frame of reference in relation to the empiric findings. The final conclusions are based on this chapter. The authors interpret the findings from a company neutral point of view, focusing on share holder value.

5.1 The hostile approach

The interviews state that there are different explanations to the hostile approach where the term "hostile" comes from situations where the management neglects the share holders and only cares for its own interests. The management know that if a bid would be accepted by the shareholders, the acquirer will replace the existing management which is experienced as hostile. This is why it is called a hostile takeover.

The different attitudes towards hostile takeovers are primarily depending on the perspective of the respondent. The views of the respondents are in general the same, namely that the takeover target decides whether or not the situation is hostile by choosing how to respond.

There is an essential difference in the opinion of why there are positive effects of a hostile takeover. One side evidently puts emphasis on the opportunity a hostile takeover can create for the target company's share holders. This is a value creation view where the bidding premium is the value creating ingredient. The other side focuses on the removal of a management, which to some extent neglect the interest of the share holders. This is a disciplinary view that assumes that hostile takeovers remove the ineffective management and replaces it by a more effective management.

During the last years, there has been a change in focus, from concentrating on the company's management, to an intensified focus on shareholder value. Because of today's shift of concentration from the management to the share holders, the number of hostile responses is declining.

Another indication of the change in focus is the trend within the history of M&A that buyers and lenders are becoming more selective. There is increasing emphasis on high quality deals that have realistic pricing of the bids. The realistic pricing is an important development since the board and the CEO do not actually own the company. The owners are the share holders and it is up to them to make the decision of whether to accept an offer or not. Then there will, per definition, be fewer hostile takeovers – they might secretly be hostile since the board finds it miserable to be taken over but all they can do is to keep up their good appearance in the vicious game. And then it will not be perceived as hostile.

There are indications that hostility does not always mean that the company does not want to merge or to switch management. In some cases, the interest is mutual but both the stockowners and the board perceives the bid to be inconsistent with the future value of the company, resulting in a public rejection. This kind of hostility derives from conflicting views of the value of the target company. This is consistent with the theory that if the goal is to bargain for a better offer, a hostile reaction could lead to a higher premium paid to target shareholders. One way to increase the expected premium is to initiate a multiple bidder auction by making a public hostile rejection to the bid. Thereby the company is making the bidding official to other potential bidders and thus initiate a bidder auction.



According to the interviews with investment bankers, it appears to be two different views of whether a hostile takeover is a good or bad occurrence. Two of the three investment bankers do not consider there to be any downsides to hostile takeovers. A takeover does not have to be hostile towards the stock owners and they are the ones who own the company, it is their money.

On the other side does one investment banker claim that hostile takeovers in general do not bring any positive issues. It is always much better to do it the friendly way. The negative reputation of hostile takeovers is not unfair. This view seems to come from the negative effect that a hostile takeover might have on the employees' experience of the takeover. If they feel that the acquirer behaved badly during the takeover process, there will be very hard to make it an effective acquisition. Two exceptions are takeovers of real estate companies along with financial companies.

5.1.1 Difficulties

According to theory, hostile takeovers are rare due to the fact of the bidder not having access to all relevant information concerning the target company. This theory concurs with the perception of all the respondents. A due diligence is somewhat a custom in ordinary takeover situations but it is not a possibility in a hostile situation since it requires the target management's consent. The lack of knowledge increases the bidder's risk. In any takeover situation is it important for the acquirer not only to determine the value of a prospective acquisition candidate, but also to understand the goals and needs of the seller, including the seller's perception of its company's value. Such an understanding will enhance the likelihood of a successful deal, because the buyer will be more likely to price and structure a mutually acceptable offer.

The interviews furthermore show that due diligence is a prerequisite when external financing is required since it is required by banks. Buyers and lenders will not be able to decide whether to pursue a takeover unless they have a full and detailed knowledge of the financial affairs of the target company. Since this can't be in a hostile takeover situation it forces the acquirer to use other ways to get the required amount of cash, or perhaps use stock although it is a less effective currency.

A takeover that results in a merger requires organizational changes, mainly in the target firm. This need for post merger changes creates several difficulties during the takeover. In trying to make this process smooth, the bidder approaches the board with a conditional offer. This kind of offer, commonly used by foreign bidders, is based on a prerequisite of the board's consensus through a recommendation to the shareholders. This is also called a negotiated offer and has the purpose of securing a positive position from the target company and thereby avoiding conflict. The lack of mutuality also prohibits the bidder of placing a conditional offer. The offer is considered conditional because the buyer is not required to purchase any shares if the specific number of shares is not tendered.

Usually one of the goals of a merger is to achieve savings by eliminating redundant facilities, offices and employees. An important effect of achieving the board's recommendation is to maintain the company spirit positive throughout the takeover process. In a takeover situation there is always the risk of organisational problems, everybody is in fact much dependent on keeping the employees motivated, dedicated and acting in a proper way. If it is a knowledge based company in contrast to a manufacturing company, you are very dependent of key employees and the members of the management et cetera. It is important to keep these people within the company since they consist its value, you do not want to pay for something that might walk out the door the next day. You cannot afford having everyone turned against you.



The cultural difficulties are not to be taken on lightly in any merger and the risk of becoming these problems is increased when the takeover process is hostile. This issue will immediately emerge if the acquirer is foreign, since the international takeover adds to the risk of cultural conflicts.

5.1.2 Prospects

Hostile takeovers are good since they put pressure on the management of companies. When a generous offer is received, the management takes a big risk if it chooses not to recommend the share holders to tender their shares. If the stock price rises after some time, to the level of the offer, they have made a proper decision but occasions like this can never be taken for granted. And, if the stock price remains the same or decreases the management has kept the shareholders from making a good deal. The pressure that a hostile offer puts on the management and board makes their task of value creating clear; this is after all what they are obliged to do.

One radical perception is that "*the most powerful market mechanism for displacing bad managers*". In many cases, corporate executives are managing to benefit themselves, not the shareholders, the local community or anyone else. When this is the case, the reason for takeovers is to create value based on disciplinary motives. Corporate takeovers could be perceived as an integral component of the market for corporate control. According to theory, the takeover market facilitates competition among different management teams. If the executives at a given firm are viewed as responsible for poor performance, another firm or management team can use a hostile takeover to remove the existing officers and thereby improve the performance of the acquired firm.

The offers in hostile takeovers are most likely to be more beneficial for shareholders. A trend within the history of M&A is that acquirers are becoming more selective. There is increasing emphasis on high quality deals that have realistic pricing. When hostile takeovers occur, they usually bring good business opportunities towards the stock owners. To them, a hostile takeover attempt might pose a great offer of getting a premium right away instead of having to wait, perhaps, at least a couple years before the stock would climb to a comparable level. The owners get well paid right away and have the possibility to invest the money elsewhere for further value gains. Takeovers can increase value and efficiency and move resources to their optimal uses, thereby increasing shareholder value. Sometimes, they need to be conducted in hostile circumstances to achieve these objectives.

5.2 Takeovers on the Swedish market

When a foreign investor is planning a takeover in Sweden he starts by consulting investment banks and advisors in his own country. This is usually a prerequisite when engaging in M&A activity in Sweden because of the special properties of the country's stock market relative to those of many other countries. There are mainly two closely linked aspects that make the Swedish market different from other, more Anglo-Saxon influenced markets.

Firstly, according to Mr Spence, "*the Swedish tradition of owning constellation makes the concentration of ownership much greater in large Swedish companies*". The pattern gives voting veto to a few original owners of many large Swedish corporations. This results in hostile takeover attempts being much dependent on the reaction of these few owners. The owning constellation can both make it easier or harder to achieve a takeover. By owning large shares of companies, often over a long period of time, many of these head owners get deeply committed to their investment objects and in some cases, other than pure financial interests arise. In the Anglo-Saxon world, where the ownership to a larger extent consists of institutions, funds and pension companies holding only a few percent each, it is



much easier to carry out a hostile takeover. A pension fund brings another kind of ownership with the only ambition of maximizing return. The Swedish ownership constellation is one important reason to the moderate amount of hostile takeover attempts aimed at Swedish limited companies over the years.

The second aspect, closely connected with the concentrated ownership is the system of dual share classes. The purpose of having stock with different voting values is to be able to raise stock capital by tendering the weaker kind of shares to foreign investors without declining the voting majority. Obviously, the conventional system makes a hostile takeover even more difficult of which Ericsson is a good example.

When engaging in a hostile takeover of a Swedish target company, the regulation and recommendations by the Swedish Competition Authority and Näringslivets Börskommitté must be taken into consideration. Disregarding their directives could put an end to the takeover process at an early stage. Foremost, these regard registration issues, to prevent large secret accumulations of shares, as well as preserving an open competition in the Swedish business environment.

Regarding hostile takeovers, the share holder value mindset has become quite established in the Swedish executive environment which means that there is hardly any board or management in Sweden that would counteract a generous offer. However, hostile takeovers with Swedish target firms and attempts of such are conducted now and then.

5.2.1 The telecom market and Ericsson

The telecom sector has a great intensity of events and turns. It is currently in a correction phase after the abnormal growth in 1997-2000 which resulted in over-investments in certain markets. Analysts have been predicting over the last couple of years that corporate buyers would go on shopping sprees as the economic downturn lowered the cost of acquisitions. At the same time, in difficult financial times a lot of actors feel a bit awkward about making large deals. When the prices increase and the climate becomes stronger, the business cycle tends to be rising making the investors more courageous which results in more deals. The psychology in this area is note to be underestimated.

The recent developments in the telecom market have made it expand at an increasing speed and in some cases to approach other markets.

Mr Ekström claims that the operators are exceedingly offensive in the hunt of new profits and the control of the customers and there are tendencies that they are closing in on the producing market. The operators desire the mobile phones, both on the inside and outside. Large global operators, like Vodafone and Orange, have begun to challenge the brands and positions of the mobile phone producers. Most of all, there is an intense battle between Nokia and Vodafone where both parties are trying to gain as much power as possible. Nokia does not want Vodafone to become too powerful and vice versa. A good example is the branding of the mobile phones, where Vodafone strives at creating a Vodafone Live telephone. The ambition is for the customer not to be buying a Nokia but a Vodafone telephone. This is a very interesting battle because it could result in the operator becoming closest to the customer. The view correlates to a large extent with the current discussion in media. There are many indications of significant increased competition within the telecom environment in which Ericsson operates.

Officially, Ericsson concurs with the perception that the market is changing but does not find the development threatening. Sony Ericsson does co-branding today, especially with Vodafone but does not consider this to effect their value creation.



In this battle, Nokia is fighting with all their accessible means to defend the company's position in the value chain. In this context, Vodafone is not alone; there are several operators that share the ambition – especially abroad. In England for example, Orange are following the pattern and so does 3 in Sweden. Until now, the producers and operators have been coexisting in a symbiosis like relationship that due to intense profit seeking might turn into a fierce battle. This would result drastic changes to the competition facing Ericsson and also the treat of a takeover. Some of the competitors, like Vodafone and Cisco, are known for engaging in takeover raids, sometimes hostile.

The increased focus on software on the mobile phone market has given rise to the approach of new rival parties, foremost Linux and Microsoft. Both articles and analysts concur that Microsoft is the most aggressive player with substantial resources that could be used to penetrate the market. The intentions of Microsoft are quite clear since the comment by Bill Gates "We will invest, invest and keep on investing until we have succeeded in the mobile market".

So far, the mobile phone market and especially Nokia put great effort in counteracting this development. The events has resulted in alliances being formed, an evident sign is the recent co-operation treaty between Microsoft and Vodafone to compete Nokia.

There are implications that the level of competition on the mobile phone market might skyrocket once 3G gets established since it is based on global standards which enhances the opportunities for international competition. However, the opinions vary to a large extent, the analysts contacted by the authors perceives there to be only a few candidates that fulfil the resources requirements to gain access to the market. However, there are today between three and four established 3G suppliers and another one or two Asian suppliers are expected to become established. On the other hand there is no doubt that a lot of candidates share the ambition. Even though the number of new entrants is very low, it would increase the total number of actors by between 25 and 33 percent which could be perceived as a drastic change. Ericsson sees the chance of new entrants in the 3G market as small since the barriers to enter are high and that potential entrants might be compensated by potential exits.

This development is important to consider since an increase of actors on a market generally increase the consolidation activity, if there are synergies to extract. Usually, this is the case when there are a lot of actors have the same area of expertise in the absence of market expansion. Reasons for takeovers in these situations might be to expand the size of the firm, to be able to extending the product range by complementary products, to penetrate new geographical market et cetera, within short time. Each industry that is exposed to drastic changes is also affected by restructuring within the corporate sector. The market players have to adjust to the new circumstances and that is done by joining up with others. If 3G brings such restructuring and new conditions, it should also lead to this kind of consolidation.

Another company that has been posing a threat to Ericsson is cash-rich U.S. telecom equipment company Cisco Systems Inc. This is one frequently cited candidate, both in articles and by analysts, since it is a large player in the network infrastructure side with sufficient financial resources for a take over. The suggestion of Cisco being a potential acquirer is strengthened by the company's history of frequent acquisitions.

There is large consent that Nokia have sufficient funds to carry out the takeover of Ericsson but such an act is not very likely, mainly because it would not be approved by the Swedish Authority of Competition.

There are several reasons for someone taking over Ericsson. Ericsson is a market leader in radio access technology and contains a powerful IPR – intellectual property rights, a strong



portfolio, products and customer portfolios. Ericsson would complement the core network players offering well into the radio side. It is a very international company with many local markets and it has had that for a long time.

Because of Ericsson's substantial losses in stock value, partly due to the weak finances of many large operators, the amount of capital required to accomplish a hostile takeover of the company has diminished considerably. The change of voting rights reducing the voting power of the A share holders would increase the chances of succeeding in a takeover attempt even more. Investor, and thereby the Wallenberg family, who has supported the company with more than a financial interest for a long time would lose much of their voting power. Even if supported by Svenska Handelsbanken, they would only reach about forty percent of the votes. In Swedish limited companies, like Ericsson, there is a demand for absolute majority of the votes to approve a proposal. There would obviously emerge a need for additional support for both the incumbent ruler of Ericsson to get any proposal approved, if the voting value is changed. At the moment Ericsson's voting structure is an important reason for putting potential bidders off. According to Swedish law concerning limited companies, a corporation holding more than 9/10 of a subsidiary has the legal right to demand to bail out the remaining stockowners. If a potential acquirer of Ericsson would want to accumulate all shares, a coercive offer would only be possible with the consent of both the Wallenberg family and Svenska Handelsbanken. If an exclusive ownership is the ambition, there can be no hostile takeover without first negotiating with the two main investors, whether or not the voting system is changed. However, there are alternatives besides an exclusive ownership.

If an offer would come up, there are two aspects to consider. Firstly, the management has to determine if this makes sense, from a strategic perspective. Then the share holders must decide from a financial perspective if it makes sense to them. When a generous offer is received, all interested parties have to be notified.

It would be difficult for Ericsson to turn down a generous offer since it would mean that either Investor or Industrivärden, or both, would have to motivate such a decision to their shareholders. This could be done by Investor since it is foremost a family owned company. Industrivärden, on the other hand, which has more of a pure profit maximizing ambition, would probably find this more difficult. The management would of course also have a say, but due to the shareholder mindset they would probably not show hostility towards most potential bidders. Ericsson has no evident or official poison pills but perceives the company's strong cash position and the A and B share system to give rise to similar deterring effects.

When engaging in takeover attempts on large Swedish corporations like Ericsson, there is always the risk of interfering with the regulation of the Swedish Competition Authority. If the acquirer would become dominating if he also owns Ericsson, then the situation is without prospects.

According to Mr Aspenberg, there are no absolute reasons for a takeover of Ericsson not happening but it largely depends on who the buyer is and what his objectives are. Ten years ago, a takeover would have been impossible because of restricted shares not allowing foreigners to buy. But the issue is not influenced so much by politics anymore. The two share class system may be a hindering factor but also an enabling factor for a takeover of Ericsson. As the voting system is configured today, the success of a hostile or friendly takeover is ultimately determined by the two head shareholders, today controlling over 70 percent. Without any of the consent of any of them, a takeover attempt would be pointless. Otherwise, in Ericsson's case size is the only factor that would prevent or slow down a takeover. This opinion implies that a potential acquirer is likely to be a much larger company than Ericsson.



5.2.2 Valuation of Ericsson

The authors have used Aswath Damodarans approach in choosing the accurate valuation model.²¹² This approach formed a model using the Free Cash Flow to Firm where the current earnings were replaced with normalized earnings, used in a stable growth model in the low growth scenario and used in a two-stage model in the high growth scenario. In addition, it is appropriate to conduct a relative valuation.

Cash flow valuation

When valuing a firm it is important to value the firm's actual performance based on the firm's core business and core operations, therefore exclude income and expenses from non-core operations such as financial assets²¹³. The authors believe that all Ericsson do is core business therefore are all operations core business. This means that information in the balance sheet and income statement are used without adjustments.

The Sony Ericsson Mobile Communications, SEMC, company is strong brand and Eriksson's part of the company sales contributes with revenues in size of about 20 percent of Ericsson's sales from the other operations. The sales from the mobile operations are close connected to Ericsson's over all operations and the average operating margin that the authors use are calculated from the years before the creation of SEMC joint venture company. Therefore are the authors' opinions that the sales from SEMC should be incorporated in the calculations of future cash flows. Unfortunately, Ericsson reports the net result from SEMC in the balance sheet section in their annual reports and the earnings briefly in the quarterly reports for the Ericsson company. Because of this lack of detailed information of the cash flows generated from SEMC we are forced to only include the net result as it is reported in the balance sheet and not as we would like to, in the cash flow calculations.

Since Ericsson generates abnormal earnings in a negative sense, the authors have chosen to use an average operation margin approach to normalize the earnings used in the valuation process. Using the average operating margin to calculate Ericsson's EBIT provides a more accurate view of the company's ability to earn money if there were a normal situation today, assuming that the company will return to normal performance in the future.

The authors have presented the information below as focused as possible on the central numbers and values in the calculations. All excluded details in the calculations are found in appendices last in this thesis.

The moderate scenario

As mentioned above, is the calculations based on normalized earnings to correct the negative earnings and achieve an accurate equity value, with the prerequisite that Ericsson is a going concern.

²¹² Damodaran, A., 2002, *Investment valuation*, P. 955

²¹³ Hamberg, M., "Understanding financial statements", September 18 2003



The table below shows the fundamentals and the result of the calculation.

Components and results of cash flow valuation, moderate scenario	
Average operating margin	9,92%
Growth, equal to the economy ²¹⁴	3,8%
Normalized EBIT2002 (MSEK)	14464,9
EFCFF ₂₀₀₃ (MSEK)	5301,61
Ericsson beta	2,37
Cost of Capital, WACC	10,28 %
Value of equity (MSEK)	48245
Equity market value (MSEK)	206 724,16
Difference (MSEK)	-158 479,16

The stock market is valuing Ericsson 2003-12-31 to MSEK 206 724 and according to the calculation Ericsson is worth MSEK 48 245 which implies that the company is over valued with MSEK 159 479. The calculated value is differing greatly to the market value, mainly because the valuation of Ericsson and the company's future performance are done very cautious and through the eyes of a low risk investor. The authors are not suggesting that their valuation is more correct than the valuation of the market. In a conservative world with a poor look of the future of Ericsson and perhaps the telecom industry as a whole, this would probably be the level where the Ericsson share price would be.

$$\text{Share value} = \frac{48\,245}{15\,974\,258\,678} \times 1000\,000 = 3,02 \text{ SEK}$$

However, a share price of 3,02 is calculated based on future circumstances that is unlikely to occur but is nevertheless important to have this not so good scenario in mind. It is useful to compare the share price computed in the moderate scenario with the value that the authors consider to be a realistic value of Ericsson equity today.

High growth scenario

In this scenario, which includes positive views of the future performance of Ericsson, the company is valued with a two stage model. The first stage is a high growth stage where the growth is assumed to be 13,8 % a year for five years. This growth rate is computed as the growth rate of the economy adjusted by adding 10 % units. This adjustment is done to reflect the expected positive effects of the restructuring program conducted by Ericsson and that should be ended in the beginning of 2004. Then there are a positive outlook for the telecom business and especially the expected upturn in orders from telecom networks which is expected to have a considerable positive effect in Ericsson economic performance. There are some expectations that the growth in telecom equipment business will be about 19%²¹⁵ and other that say about 6 %²¹⁶ a year. The authors choose to be slightly optimistic in the

²¹⁴ <http://www.finans.regeringen.se>, December 31 2003

²¹⁵ <http://pages.stern.nyu.edu>, December 28 2003

²¹⁶ Chapman-Pincher, P., "Lights out in the new network", *Financial Times*, November 2003, p. 52



calculations and use an expected growth, as said above, of 13,80 %. The beta value used in the high growth period is the same as in the moderate scenario, 2,37²¹⁷.

After 4 years we assume that the company will go into a stable growth with a growth rate of 3,8 % a year for infinity. In this case the beta is set to 1,0 due to the infinity time horizon. All other values and conditions remain the same as in the moderate scenario.

The result of the calculation in the high growth scenario is summarized in the overview below.

Components and results of cash flow valuation, high growth scenario	
Average operating margin	9,92%
Growth, equal to the economy	13,80 %
Normalized EBIT2002 (MSEK)	14464,9
EFCFF ₂₀₀₃ (MSEK)	5301,61
Ericsson beta, Stable growth	1
Ericsson beta, High growth	2,37
Cost of Capital, High growth, WACC	10,28 %
Cost of Capital, Stable Growth, WACC	7,55 %
Value of equity (MSEK)	194 373,93
Equity market value (MSEK)	206 724,16
Difference	-12 350,23

The equity's value a share is computed by dividing the calculated equity value by the number of outstanding shares:

$$\text{Calculated share value} = \frac{194\,373,93}{15\,974\,258\,678} \times 1000\,000 = 12,17 \text{ SEK}$$

Conducting the same calculation on the equity market value gives the market value a share:

$$\text{Market share value} = \frac{206\,724}{15\,974\,258\,678} \times 1000\,000 = 12,94 \text{ SEK}$$

As shown above is the stock market valuating Ericsson to MSEK 206 724 and according to our calculations Ericsson is worth MSEK 194 374. The calculated share value of 12,17 is close to the market share price of 12,94. This suggests that the market is calculating with a growth in a similar way as in the calculations above. Still, the company could be considered to be over valued, in this case by MSEK 12 350 which is more in line with the market expectations of the future performance of Ericsson.

²¹⁷ The beta used by analysts might differ from the used regression beta of 2.37. According to Mr Irfeldt at Swedbank, the beta used by analysts is often adjusted to reflect qualitative information. The authors do not have access to that sort of information.



Relative valuation

The authors have identified three candidates as parties with an interest in taking over Ericsson. The selection was based on financial facts about the companies, articles describing the circumstances and expert opinions collected from interviews.

Microsoft would expand its product range even more, strengthen their position in the market since when software and telecom are synthesizing and perhaps revolutionize the software market once more.

If Microsoft managed to conduct a takeover of Ericsson it would result in a vertical merger. The companies might not have that much in common until recently when Microsoft engaged in mobile software development.

Cisco Systems already competes with Ericsson and would through a takeover to a large extent increase its market share and customer base, fill in gaps in competence, create synergies, economies of scale and extend its product range by entering the mobile phone market.

A takeover of Ericsson by Cisco would result in a horizontal merger. Both companies are in general competing in the same kind of business activity. The new entity would have some competing products but this is not an unusual aspect in M&A. The takeover would have a strategic incentive in removing one of Cisco's major competitors and at the same time evolve the width of the company's competence, for example by incorporating mobile phones and military products.

Vodafone would finally get their own telephone, be able to control the whole value chain, and become a full competent operator and producer able to offer complete solutions.

A merger with Vodafone would result in a vertical merger since the firms are active in different stages of the production and service operation. Transactions within the new entity might eliminate the cost of searching for prices, contracting, payment collection, and advertising. One main reason might also be to reduce the cost of communication and of coordination production. There could be a more efficient information flow within a single firm, enhancing planning for inventory and production.

One of the largest problems with any of these potential takeovers is the possibility of a prohibition by the Swedish competition authority to close the deal. Especially in the case of Cisco since horizontal mergers are exceptionally sensitive in these circumstances.

In the relative valuation Ericsson is compared to its closest competitors and to the firms that are potential acquirers by a selection of common key ratios. This is presented below in table 1.

**Table 1; Key ratios²¹⁸**

Company:	Ericsson	Nokia	Siemens	Motorola	Microsoft	Vodafone	Cisco
Gross operating margin %	-18,39	16,29	4,21	3,87	35,52	-15,94	26,68
Profit margin %	-16,16	11,91	3,38	2,21	30,26	-27,88	21,15
Beta	2,37	2,04	1,761	1,1	1,725	0,917	2,293
ROE %	-27,44	24,72	10,17	5,01	16,51	-6,36	14,44
ROC %	-11,72	15,16	3,27	1,9	12,9	-5,62	11,01
P/E	86,48	18,72	23,52	58,47	30,2	-10,11	42,92
Shares (x1000)	1 547 604	4 796 292	890 866	2 327 767	10 812 470	6 805 686	6 903 338
NYSE							
share price	18,16	17,17	80,17	14,5	27,45	25,31	24,25
Value of equity							
BUSD	28 104	82 352	71 421	33 753	296 802	172 252	167 406

The gross operating margin and profit margin are negative for Ericsson and Vodafone, this show that both companies have negative earnings. Consequently is return on capital and return on equity negative for the both.

Nokia has the best return on equity which shows that they create the most share holder value for its stockholders.

Nokia also has the highest return on capital, but just slightly better than Microsoft and Cisco Systems. Microsoft and Cisco systems have the largest margins, meaning that they have the highest profitability on their sales.

A noticeable variation in the values is in the P/E value line where Ericsson has a significant higher P/E ratio than the other companies. This suggests that Ericsson is highly valued on the market. Another noticeable value is that the beta value for Ericsson is the highest, which implies that the company risk is highest in Ericsson. Close to Ericsson is Cisco Systems with a beta on 2,293 which is also to be considered as sign of high company risk.

The overall picture is that Microsoft is distinguished with its economical strength and good performance, having good values in all key ratios and it is the considerable largest actor in the table according to market value. The lowest figures are presented by Ericsson, with its poor financial performance and high valued equity according to the P/E-ratio.

It is evident that that the company is underperforming and less profitable relative to the other companies. According to theory, these are typical characteristics of a target firm in a hostile takeover.

²¹⁸ <http://finance.yahoo.com>, January 3 2004



6 Conclusion and end discussion

In this final section, the authors present their conclusions supported by a discussion. The ambition of this chapter is to fulfil the purpose of this thesis. Finally, this chapter contains a recommendation regarding extend research.

In the initial part of this thesis, the authors stated its general purpose:

"to examine how the risk of a hostile takeover attempt on Ericsson is affected by the Swedish business environment."

There are different explanations to the hostile approach where the term "hostile" comes from situations where the management neglects the share holders and only cares for its own interests. This applies in situations where the management knows that if a bid would be accepted by the shareholders, the acquirer will replace the incumbent management. The authors perceive the hostility to derive from the attitude of the target company's management. A hostile takeover is a situation when the offer is rejected by the target firm, often in an aggressive way.

If the executives at a given firm are viewed as responsible for poor performance, another firm or management team can use a hostile takeover to remove the existing officers and thereby improve the performance of the acquired firm. Thereby the acquirer identifies an opportunity to make profit. Takeovers can bring several kinds of benefits, for instance to increase value and efficiency and move resources to their optimal uses, thereby increasing shareholder value. When the management of a target firm opposes a takeover, conducting a hostile takeover provides the important function as a last option for the acquirer.

The modest amount of hostile takeovers conducted in Sweden is due to some of several factors. Those are essential to take into consideration when preparing a hostile takeover with a Swedish target company.

The first issue contributing to the quite modest threat of a hostile takeover of Ericsson is the Swedish ownership structure. As in many several Swedish firms, the ownership is constructed mainly by a few head owners who control a vast majority of the voting power. Many of these head owners have a profound devotion in their investment objects which differs from the pure profit driven interest. This fact makes them less interested in selling their share, especially to foreign investors who might have a slightly different agenda.

In the case of Ericsson, there are two head share holders who controls over seventy percent of the voting rights. This concretizes the issue since without the consent of any of them, a takeover of Ericsson is impossible. Especially in cases where the objective is to become an exclusive owner. This fact is important since it is similar to the situation of many large Swedish companies.

A second issue is the Swedish system of dual share classes with different voting values. It often makes the original shareholders, in companies that apply the system, very powerful. Especially in old companies that can utilize a one thousand to one ratio of the voting value. These rules make it harder to acquire the control of Swedish companies since fewer A-shares are required to obstruct such a deal.

The authors believe that the fact of Ericsson not applying any takeover defences is a sign of the company relying on the dual share class system. Since Ericsson has not been targeted for takeover attempts or felt threatened by such, despite the volatile environment in which the company acts, the system can be perceived to be stable and effective. It is reasonable to believe that in the fierce competition on the telecom market, Ericsson would have been



encountered by takeover attempts because of the company's major drop in share value. This clearly exemplifies the protective and deterring mechanism of the dual class share system.

A negative issue of the dual share class system is that the head owners do not have to possess a great part of the share capital by owning A-shares. Since the influence relative to stake is much higher for the A share holders, they get less incentive to care for share holder value or return, at all times. The main incentive for a major B-share holder in a company like Ericsson, is to gain maximum return on invested capital, i.e. shareholder value.

The decreasing rate of hostile takeovers in the Swedish stock market is due to the fact that hostile responses have become perceived as more political incorrect. A number of the accommodated takeovers conducted in recent years in Sweden would have been hostile in the past because of the different attitude of managements. Managements of many Swedish companies, which are confronted with an offer, would probably like to counteract it since it threatens their job and prestige. However, such an act would conflict with the share holder value mindset and thereby with their executive obligations. The result is that the number of official hostile takeovers is decreasing while it is likely that the management in many cases still experience hostility in the situations. The authors perceive this trend to be positive since it supports the position of the share holders and brings additional influences of the invisible hand to the financial market.

Since the trend has put focus on share holder value it is likely to believe that Swedish system of dual share classes will eventually go through changes and its protective effect will decrease. Another reason for this point of view is that national market legislation is striving towards international harmonization.

According to the relative valuation, Ericsson is high valued. It seems like the market is including better profitability, perhaps due to recovered finances and regained ability to earn money on the company's core business. This is also indicated by the cash flow analysis which shows that the market is valuing Ericsson higher than the authors are. This implies that the market is expecting a higher growth or a decrease in cost of capital or a combination of the both. The current stock rate reflects the expectations by the market of increased profitability. These expectations are rather high according to the authors view, which means that they find Ericsson to be overvalued – mainly because of its humble ability to generate profit in the current situation.

The authors believe that the market's expectation of an upturn of Ericsson's profitability is likely to lower the chance of a hostile takeover attempt in the near future. This would be the case since the share holders probably will be satisfied if the company is able to meet the expectations and thereby give a good return. But if the company fails to do so within a proper time frame, it is likely that dissatisfaction will arise amongst the shareholders and thereby increase the risk of a hostile takeover.

However, it is evident that the company does share a majority of the characters of typical hostile takeover targets. Ericsson has underperformed many other stocks in the telecom industry and the overall market in terms of returns to its stock holders during the last years. The company has also been and still is, less profitable than many firms in its industry.

The company's low profitability and high cost of capital makes it reasonable to believe that there is little reason for launching a financial takeover of Ericsson today. Still, the authors perceive Ericsson to be an attractive takeover target due to its core values and its potential future gains. There are several gains that could be apprehended since the businesses of the potential acquirers are likely to be quite similar to Ericsson's, which is a prerequisite for creating synergies. In addition, there are strategic incentives i.e. penetrating new product and geographic markets, gaining access to established brands and the company's IPR



portfolio. Several candidates have the size and resources to accomplish the task. Many of these are aggressive players; Microsoft and Vodafone for instance, have the necessary resources and whose ambitions are not to be understated.

It appears that Ericsson will continue to be unthreatened until the internal balance of power changes. The secure position for the management in many ways eliminates the disciplinary effect of a hostile takeover attempt which might explain why, despite the economic difficulties during the last years, there has been little change in the executive management of the company.

However, no company is safe from the threat of a hostile takeover. If the acquirer is deeply dedicated and has large hard cash resources, all listed companies have reason to feel exposed.



7 Proposals to extended research

During the course of the work, the authors have encountered an abundance of different areas that would be interesting to examine in greater detail. The limited time frame of this thesis does however prevent the authors from making a more extensive research which leads to them present these issues as proposals to extended research.

The authors would find research concerning the following issues to be of great interest, for example:

- Have the general incentives for conducting hostile takeovers changed over the years, perhaps because of technological and social developments?
- How would the political discussion evolve if a serious tender offer was given to Ericsson? Possible outcomes of such an act?
- Further research of the M&A activity on the telecom market and its movements. This is an area that changes rapidly and new interesting circumstances arise continuously.
- How would the balance of power be changed of large Swedish companies if the dual share class system was abandoned?
- Ericsson is known for experiencing difficulties in making profits on their products. How would a head ownership by Sony affect Ericsson's profitability?



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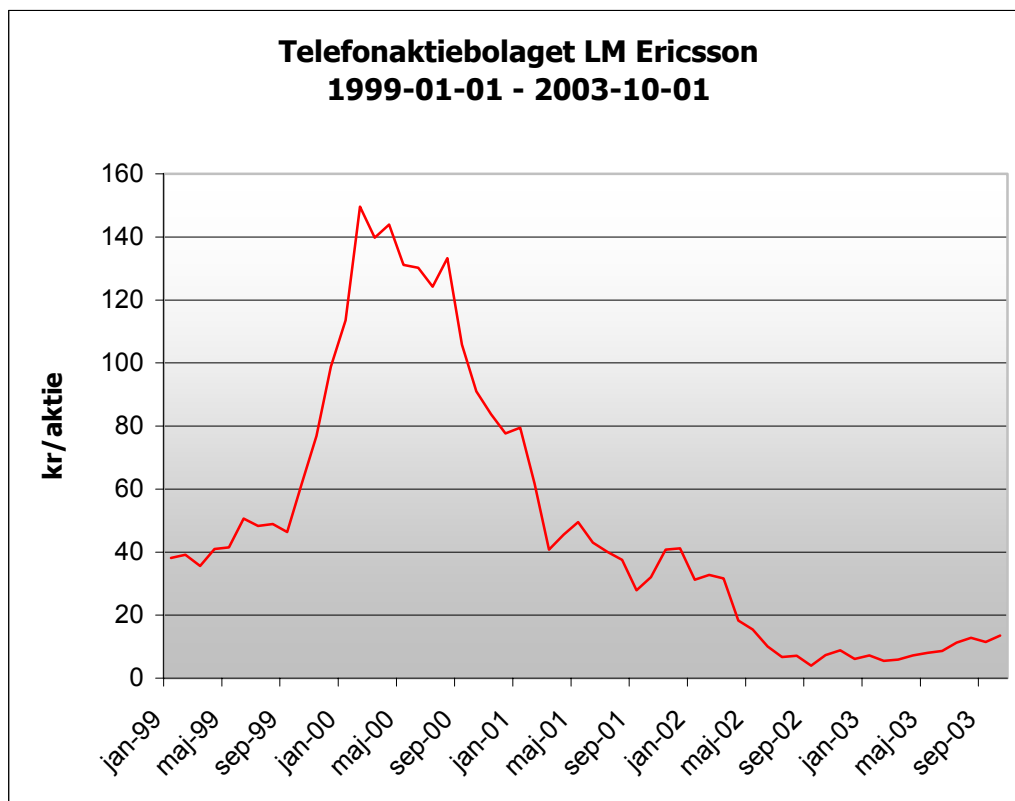
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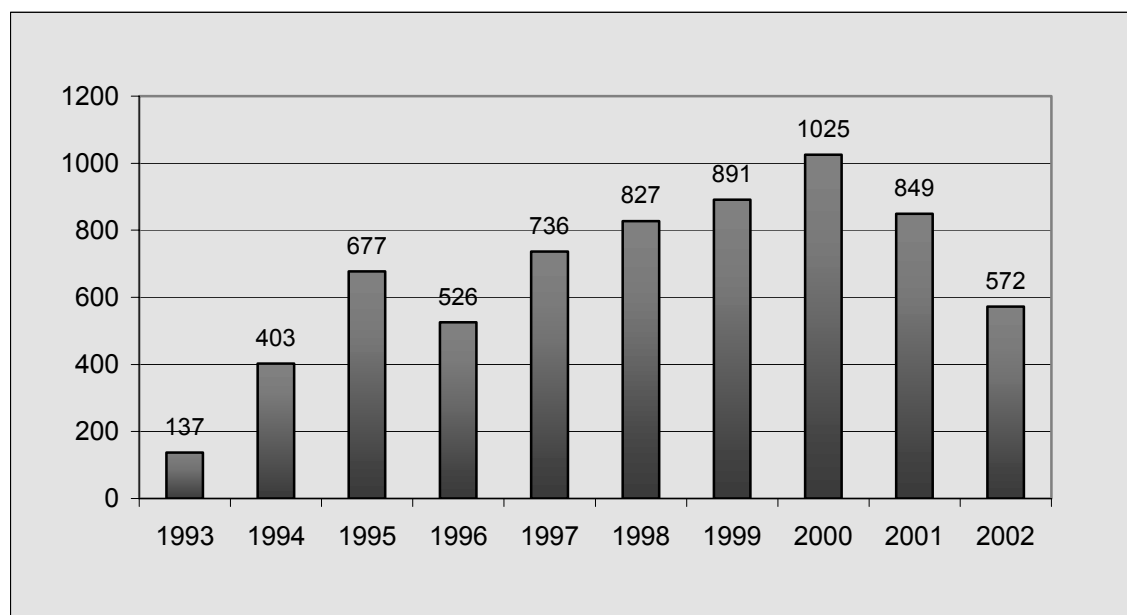
Appendices

Appendix A: The development of the LM Ericsson stock



Max	2000-02-01	149,681
Min	2002-09-23	3,92
Diff		97,38 %

Source: <http://www.di.se> December 31 2003

**Appendix B: The takeover market in Sweden**

Source: <http://forvarv-fusioner.nu> December 31 2003

Appendix C: The ten largest listed companies in Sweden and their head owners 2002

Company name	Number of employees	Operating revenue / turnover
AB VOLVO	70546	21098923,51
ERICSSON	53945	16968385,27
SKANSKA AB	76358	16529178,47
AB ELECTROLUX	81971	15103116,15
SVENSKA CELLULOZA AB SCA	43374	10094617,56
SECURITAS AB	203070	7443093,48
SAS AB	35506	7359093,48
TELIASONERA AB	17277	6864362,61
SANDVIK AB	36118	5567932,01
ATLAS COPCO AB	25787	5413371,11

Head owner: Investor, Industrivärden, Swedish government, other (thousands of USD)

Source: <http://amadeus.bvdep.com> December 31 2003

**Appendix D: The owner constellation of Ericsson**

Head stock holders December 31 2003	Capital, %	Votes, %
Investor AB	5.34	38.31
AB Industrivärden	2.50	27.73
Svenska Handelsbankens Pensionsstiftelse	0.44	5.29
Livförsäkrings AB Skandia	1.79	4.95
Pensionskassan SHB Försäkringförening	0.40	4.72

Source: www.di.se December 31 2003



Appendix E: Ericsson extended valuation process

Moderate scenario

In order to achieve the accurate equity value we base our calculations upon normalized earnings. These are calculated by determining the average operating margin for the years 1998-2000 and are shown in the table below.

Average operating margin			
Year	2000	1999	1998
Sales	273 569	215 403	184 438
EBIT	30 828	17 469	19 163
EBIT/sales	11,269 %	8,110 %	10,390 %
Average operating margin		9,923 %	

As we see is the average operating margin 9,923 % and with this we calculate the normalized EBIT for year 2002 by using it on the sales for year 2002.

Normalized EBIT 2002	
Normalized EBIT = sales * average OM	
Sales 2002	145773
Average operating margin	9,923 %
Normalized EBIT₂₀₀₂ (MSEK)	14464,90

Now we have the earnings before interest and taxes that we will use in the Free Cash Flow to Firm model, FCFF. The tax rate, t , in the calculation is 28 %.

The next step is to determine the reinvestment rate for Ericsson. This is done by dividing the expected growth, g , with the return on capital invested in the firm, ROC.

The average return on capital during the years 1998 to 2000 was calculated 7,46 percent. The expected growth are in this scenario equal to the growth in the economy as a whole which is expected to be 3,8 percent for 2004 and slightly raising but we have used 3,8 percent as a expected growth for infinity in this moderate scenario²¹⁹.

Ericsson's reinvestment rate is then computed to be 50,96 %. The expected free cash flow to the firm for 2003 is calculated to MSEK 5301,61 as shown by the table below.

Expected free cash flow to the firm (EFCFF) 2003:	
EBIT ₂₀₀₂ (1+g) (1-t) (1-Reinvestment rate)	
EFCFF₂₀₀₃ (MSEK)	5301,61

²¹⁹ <http://www.finans.regeringen.se>, December 31 2003



The expected free cash flow to firm, $EFCFF_{2003}$ is used to calculate the value of operating assets which are computed by the formula:

$$\frac{EFCFF_{2003}}{\text{Cost of Capital} - \text{Expected growth}}$$

The cost of capital in this case is the weighted average cost of capital, WACC.

The Weighted Average Cost of Capital

The weights of debt and equity of Ericsson is calculated on the market value of equity and the book value of debt.

$$WACC = W_e R_e + W_d (1 - T_c) R_d$$

To estimate the cost of capital for Ericsson we computed weights on the market value of equity of 99 084 MSEK at the end of 2002 and the total debt to 99 837 MSEK. These values gives equity the weight of 0,4981 and debt the weight of 0,5019.

Ericsson's cost of equity, R_e , is computed by using the capital asset pricing model, CAPM.

The cost of equity for Ericsson is calculated by the CAPM formula

$$R_e = R_f + \beta(R_m - R_f)$$

- Risk free rate, R_f
The risk free rate used in the calculations is a 5 year government bond with a bond rate of 4,325 %.²²⁰
- The beta value, β
Ericsson's beta value on the New York Stock Exchange is 2,37 and this is the beta value used in this calculation.²²¹
- The market return, R_m
In order to calculate the cost of capital one has to know the markets demand for return on any single investment, known as the R_m .
The market return is the expected return on a market portfolio²²². This value can be taken from the return on a market index, for example the S&P 500²²³. The large actors on the Swedish capital market calculate the R_m on the Swedish market as the

²²⁰ Riksgäldskontoret, November 17 2003

²²¹ www.nyse.com, November 18 2003

²²² Pinches, G. E., 1996, *Essentials of financial management*

²²³ Weston, J., Michell, M. L., Mulherin, J. H., 2003, *Takeovers, Restructuring and Corporate Governance*



sum of 5 year risk free bond rate plus a risk premium on 4 – 4,5 percent²²⁴ and the same model for the R_m is used in this thesis. The 5 year risk free government bond rate of 4,325 percent is used²²⁵. If considering that the state of the Swedish economy is slowly turning upwards it is correct to use 4 percent as the risk premium in the calculations²²⁶.

By using this model, the market return, R_m , is calculated as

$$R_m = 4,325 + 4,0 = 8,325 \%$$

Now, all the elements for computing the cost of equity for Ericsson and the CAPM formula is available, giving the cost of equity by following equation:

$$R_e = 4,325 + 2,37 * (8,325 - 4,325) = 13,805 \%$$

The cost of debt is thereafter calculate as the financial expenses from the income statement for 2002 divided by the company's interest bearing debt and pension liabilities by the end of 2002.

Pensions are included because the financial expenses include the interest expenses for pensions. There is no further information of the details that makes it possible to separate these expenses.

$$\text{Cost of debt, } R_d = \frac{5789}{50541 + 10997} = 9,407 \%$$

By using all the values, the cost of capital, WACC, for Ericsson can be calculated:

$$\text{WACC} = 0,4981 * 13,805\% + 0,5019 * (1 - 28\%) * 9,407\% = 10,2758 \%$$

The value of the operating assets is then calculated:

$$\text{Value of operating assets} = \frac{5302}{10,2758\% - 3,8\%} = 81868 \text{ MSEK}$$

To arrive at the company's value of equity; cash and marketable securities are added and debt subtracted from the value of operating assets, as shown below:

$$\text{Value of equity} = 81\ 868 + 66\ 214 - 99\ 837 = 48\ 245 \text{ MSEK}$$

With a total number of 15 974 258 678 outstanding shares, the share price of Ericsson according to this calculation should be SEK 3,02.

²²⁴ Robur, Nordea Fonder, Näringsdepartementet, November 27 2003

²²⁵ Riksgäldskontoret, November 27 2003

²²⁶ Näringsdepartementet, November 27 2003



The equity value is compared to the stock markets value of Ericsson 20031231. The table below shows the market value of each stock and the total value of Ericsson's equity according to the Swedish stock market 20031231²²⁷.

Market value of equity 20031231	
No of A shares	656 218 640
No of B shares	15 318 040 038
Stock price A Share (SEK)	13,90
Stock price B Share (SEK)	12,90
Equity market value (MSEK)	206 724,16

The stock market is valuating Ericsson 2003-12-31 to MSEK 206 724 and according to the calculations, Ericsson is worth MSEK 48 245 which means that the company is over valued with MSEK 159 479. The calculated value is differing very much to the market value, mainly because the authors' valuation of Ericsson and the company's future performance is done very cautious and through the eyes of a low risk investor. In a conservative world with a skeptic view of the future of Ericsson, this would probably be the level of the Ericsson share price. However, a share price of SEK 3,02 is calculated based on future circumstances that is unlikely to occur. Nevertheless, it is important to have a not so good scenario in mind. It is useful to compare the share price computed in the moderate scenario with the value that the authors consider be a realistic value of Ericsson equity today.

High growth scenario

In a high growth scenario, which includes optimistic views of the future performance of Ericsson, the company is valued by using a two stage model. The first stage is a high growth stage where the growth is assumed to be 13,8 % a year for five years and is computed as the growth rate of the economy adjusted by adding 10 % units. This adjustment is done to reflect the expected positive effects of the restructuring program conducted by Ericsson and that should be ceased in the beginning of 2004. Then there are a positive outlook for the telecom business and especially the expected upturn in orders from telecom networks which is expected to have a considerable positive effect on Ericsson's economic performance. There are some expectations that the growth in telecom equipment business will be about 19 % but the authors have chosen not to be that optimistic in their calculations²²⁸. The beta value used in the high growth period is the same as today, 2,37.

After 4 years, the company is assumed to enter a stable growth with a growth rate of 3,8 % a year for infinity. In this case, the beta is set to 1,0 due to the infinity time horizon.

All other values and conditions remain the same as in the moderate scenario.

Firstly, the costs of equity in high growth (hg) and stable growth (sg) are estimated. The values are calculated as shown below:

$$\text{Cost of Equity}_{hg} = 4,325\% + 2,37 * (8,325\% - 4,325\%) = 13,805\%$$

$$\text{Cost of Equity}_{sg} = 4,325\% + 1,00 * (8,325\% - 4,325\%) = 8,325\%$$

²²⁷ <http://bors.affarsvarlden.se>, December 31 2003

²²⁸ <http://pages.stern.nyu.edu>, December 28 2003



To estimate the cost of capital, the authors assume that the cost of debt and the weights of equity and debt will remain the same over the valuation period. The cost of capital is then calculated as

$$\text{Cost of capital}_{hg} = 0,4981 * 13,805\% + 0,5019 * (1-28\%) * 9,407\% = 10,276\%$$

$$\text{Cost of capital}_{sg} = 0,4981 * 13,805\% + 0,5019 * (1-28\%) * 9,407\% = 7,546\%$$

Since the normalized earnings and reinvestment rate are unchanged, the cash flows for the high growth period can be calculated. The present values are computed by discounting the cash flows by the cost of capital for the high growth period, 10,276 %.

Expected cash flows during high growth period					
Year	EBIT(1-t) = EBI	Reinvestment rate	Reinvestment	FCFF	Present value
current	10 414,73	50,96%			
1	11 851,96	50,96%	6 039,60	17 891,56	16 224,38
2	13 487,53	50,96%	6 873,24	20 360,77	16 743,03
3	15 348,81	50,96%	7 821,54	23 170,35	17 277,95
4	17 466,94	50,96%	8 900,92	26 367,86	17 830,13
5	19 877,38	50,96%	10 129,24	30 006,62	18 399,95
Sum of PV of cash flows (MSEK)					86 475,43

In the following step, the earnings after tax but before interest from year 5, EBI_5 , is used and calculate the free cash flow to firm for year 6, $FCFF_6$:

$$FCFF_6 = EBI_5 * (1 + \text{stable period growth}) * (1 - \text{Reinvestment rate})$$

$$FCFF_6 = 19 877,38 * (1 + 3,8\%) * (1 - 50,96\%) = 10118,57 \text{ MSEK}$$

The Ericsson's terminal value year 6 is then calculated by:

$$\text{Terminal value} = \frac{FCFF_6}{\text{Stable period cost of capital} - \text{stable period growth}}$$

$$\text{Terminal value} = \frac{10 118,57}{7,546\% - 3,8\%} = 270 105,681$$



The terminal value by year 6 is 270 106 MSEK and in order to work out the value of Ericsson's operating assets we need to determine the present value of the terminal value with the formula below.

$Present\ value_{Terminal\ value} = \frac{Terminal\ value}{High\ growth\ period\ cost\ of\ capital^5}$		
$Present\ value_{Terminal\ value} =$	$\frac{270\ 105,681}{10,276\ \%^5}$	$= 141\ 521,4952$

Now we can compute the value of operating assets as the sum of the present value of cash flow in the high growth period added to the present value of the terminal value.

$$Value\ of\ operating\ assets = 86\ 475,43 + 141521,4952 = 227\ 996,93\ MSEK$$

As we did in with the moderate scenario we now add, to the value of operating assets, the company's cash and marketable securities. Thereafter we subtract the company's debt and obtain the value of Ericsson's equity.

$$Value\ of\ equity = 227\ 996,93 + 66\ 214 - 99\ 837 = 194\ 373,93\ MSEK$$

To arrive at the equity's vale a share we divide the equity vale with the number of outstanding shares:

$Share\ value =$	$\frac{194\ 373,93}{15\ 974\ 258\ 678}$	$\times 1000\ 000 = 12,17\ SEK$
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As shown above is the stock market valuating Ericsson to MSEK 206 724 and according to our calculations Ericsson is worth MSEK 194 374. This means that the company is over valued with MSEK 12 350.

**Appendix F: Ericsson valuation data**

Moderate scenario

Normalized EBIT 2002

Normalized EBIT = Average Operating profit margin * earnings

Average OM = (EBIT / Sales) / no of years

	2000	1999	1998
Sales	273 569	215 403	184 438
EBIT (OpInc)	30 828	17 469	19 163
EBIT / sales	11,269 %	8,110 %	10,390 %
Average OM (1998 - 2000)		9,923 %	

Normalized EBIT 2002 = sales 2002 * average OM

Sales 2002 145773

Average OM 9,923 %

Normalized EBIT 2002 (MSEK) 14464,90**Average return on capital (1998-2000)****(EBIT(1 - t))/(BV of debt + BV of equity)****t = 28%**

	2000	1999	1998
EBIT(1 - t)	22196,16	12577,68	13797,36
Book value of Capital	263 282	211 412	172 658
Return On Capital	8,43 %	5,95 %	7,99 %
Average ROC	= 7,46 %		

Reinvestment rate

Growth = equal to the economy

Growth, g = 3,80 %**Reinvestment rate = g / ROC = 50,96 %****Expected free cash flow to the firm (EFCFF) 2003:**

EBIT2002(1+g)(1-t)(1-Reinvestment rate)

EFCFF 2003 (MSEK) = 5301,61**The Cost of Capital per 20021231****Cost of Equity, Re = CAPM = Rf + β(Rm - Rf)**

Beta Coefficient, β = 2,37

Risk free rate, Rf = 4,325 %

Market return, Rm = 8,325 %

Re = 13,805 %



Cost of Debt, Rd

Rd = Interest expenses / Interestbearing debt+pensions
Rd = 5789 / (50541+10997) = 9,407 %

Estimating the weights in the WACC

Equity	Market value of equity 20021231:		
	No of A shares		656 218 640
			15 318 040
	No of B shares		038
	Stock price A Share (SEK)		8,60
	Stock price B Share (SEK)		6,10
	Equity market value (MSEK)		99 083,52
Debt	Book value of debt 20021231		
	Long-term liabilities		
	Notes and bond loans		33 074
	Liabilities to financial institutions		3 043
	Other long-term liabilities		949
	Current liabilities		
	Current maturities of long-term debt		11 083
	Current liabilities to financial institutions		2 392
	Total current liabilities		13 475
	Interest bearing debt		50 541
	Total debt		99 837
Weights	Weight Equity, We = E / (E + D)		0,4981
	Weight Debt, Wd = D / (E + D)		0,5019

Cost of Capital using the WACC

Weight Equity, We = 0,4981
 Weight Debt, Wd = 0,5019
 Cost of Equity, Re = 13,805%
 Cost of Debt, Rd = 9,407%
 Company tax rate, t = 28,00%

WACC = We * Re + Wd(1 - t) * Rd = 10,2758%

Value of operating assets

Value of operating assets = EFCFF2003/(Cost of Capital - Expected growth) = **81 868,37 MSEK**

The value of equity



Value of equity = value of operating assets + cash and marketable securities - all debt

Cash and bank	17 962,00
Short-term cash investments	48 252,00
Total cash and marketbale securities	66 214,00
Value of equity = 65230 + 66214 - (37066 + 62771)	48 245,37
Outstanding shares	15 974 258 678
Value per share	3,02

High growth scenario

Normalized EBIT 2003	High growth period, hg (5 Years)	Stable growth period, sg (After 5 years to infinity)
Beta	2,37	1,00
Risk free rate	4,325 %	4,325 %
Market return	8,325 %	8,325 %
Economi growth	3,800 %	
Cost of Equity, hg Rf + Beta * (Rm - Rf)	13,805 %	
Cost of Equity, sg Rf + Beta * (Rm - Rf)	8,325 %	
Pretax cost of Debt	9,407 %	
Weight Equity, We = E / (E + D) =	0,4981	
Weight Debt, Wd = D / (E + D) =	0,5019	
Cost of capital, hg, WACC	10,276 %	
Cost of capital, sg, WACC	7,546 %	
Average Reinvestment rate, ARIR	50,960 %	
Average return on capital, AROC	7,457 %	
Expected growth rate, Eg = reinvestment rate * average return on capital	13,800 %	3,800 % + 10,000 %
Normalized EBIT2003	14464,90	



Expected cash flows during the high growth period					
Year	EBIT(1-t) = EBI	Reinvestment rate	Reinvestment	FCFF	Present value
current	10 414,73	50,96 %			
1	11 851,96	50,96 %	6 039,60	17 891,56	16 224,38
2	13 487,53	50,96 %	6 873,24	20 360,77	16 743,03
3	15 348,81	50,96 %	7 821,54	23 170,35	17 277,95
4	17 466,94	50,96 %	8 900,92	26 367,86	17 830,13
5	19 877,38	50,96 %	10 129,24	30 006,62	18 399,95
Sum of PV of cash flows					86 475,43

FCFF year 6		
Infinite growth	= 3,8 %	
ERIR	= 50,96 %	
FCFF6 = EBI5*(1+g)*(1-ERIR)		10 118,57
Terminal value	= FCFF6/WACCsg - stable g	270105,681
PV	= Terminal value / WACChg(5)	141521,4952
Value of operating assets	= PV of CFhg + PV of terminal value	227 996,93
Value of equity (MSEK)		194 373,93
Value/share		12,17 SEK



Appendix G: Interview form – Investment banks

1. How are international takeovers usually carried out when the target is a Swedish firm?
2. Why are there so few takeovers including Swedish companies?
3. How does the takeover trend in Sweden appear in comparison to the international trend?
4. How does a hostile takeover differ from a non hostile in practice?
5. What are the prospects and consequences with hostile takeovers?
6. How is the M&A activity on markets affected when there is a substantial increase of market actors?
7. How is the target company evaluated when planning a hostile takeover?
8. How can hostile takeovers affect shareholder value?
9. What characterizes the telecom market regarding takeovers?
10. How would a change of voting power of the different kinds of stocks affect the risk of Ericsson being taken over?
11. What would the stock owner's incentives be for supporting a hostile takeover?
12. How would a hostile takeover of Ericsson be carried out – what are the important criterion and obstacles?
13. Who is the most likely candidate to launch a takeover attempt?



Appendix H: Interview form – Analysts and Ericsson employees

1. How does Ericsson work to lower the high cost of capital (in order to lower the beta-value)?
2. When do you believe that Ericsson will get a better credit rating?
3. What effect do you believe that the trend of many operators increasing interest in having their own mobile phones will have? For example the way that Vodafone operates.
4. Has Ericsson received any tender offers or has there been any discussion concerning a takeover of Ericsson? Is this something that you are concerned about? Is Ericsson utilizing any defence mechanisms?
5. What do you consider to primarily make an acquisition of Ericsson difficult?
6. If you have to name one, which company would you consider to be the most likely candidate to acquire Ericsson? For example Cisco, Vodafone or Microsoft
7. How do you think Ericsson would respond to a generous tender offer was received?
8. What do you think a potential acquirer would value the most in Ericsson – what would the primary reason for launching a takeover attempt? What are Ericsson core values – what makes the company unique?
9. How do you consider the 3G-technology to affect the competition in the mobile phone market?
10. What are your thoughts about the change in the voting power of the B-shares?