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Tender Offer: The Dutch Variety

Dutch Tender Offer

This article focuses on a way to earn absolute, non-market correlated returns: the Dutch tender offer.

The thought of a Dutch-named investment may conjure up images of tulips and speculative mania. However, the Dutch tender offer cannot be anymore different. The investment opportunity is straightforward. The process begins when a company announces its intention to repurchase shares in a Dutch tender offer. Investors have the opportunity to buy shares after the announcement and tender them to the company at the expiration date of the offer.

The term Dutch auction traces its roots back to the 17^{th} century. Dutch merchants originated the Dutch auction as a way to sell flowers. Merchants conducted an auction by setting an initial price at which to sell their flowers. The price would be lowered progressively until the merchants found buyers for their entire stock. The current version of a Dutch tender offer is a modification of a pure Dutch auction. In the modified version, a company repurchases shares by initially specifying the number of shares and price range at which it will repurchase shares.

The Stock Buyback

A Dutch tender offer is a mechanism for a company to repurchase its equity or debt. Companies repurchase equity for a variety of reasons.

- In some cases, a company may use the repurchase program as an opportunity to return excess cash to shareholders.
- The repurchase of shares below intrinsic value adds intrinsic value to remaining shareholders.
- Another reason is to reduce the share count and concentrate the remaining value of the company in the hands of fewer shareholders. This may be a signal that the company believes its shares are undervalued.

Companies have a variety of ways to conduct share repurchases. These include:

- common share repurchase programs,
- negotiated private transactions,
- and tender offers.

Share repurchase programs are conducted through:

a) Open market transactions at the current market price. This strategy is usually done on an ongoing basis and may put a floor under the company's stock price, however there are legal limits, notably Rules 10b-18 and 10b-5 of the Securities Exchange Act of 1934, on the number of shares a company can purchase each day. A company may repurchase on any single day no more than 25% of the average daily trading volume over the preceding four weeks. Open market share repurchases must be made at a price not higher than the published bid or last independent sale price, whichever is higher, and may not be made at the open or during the final 30 minutes of a day's trading session. The SEC has the ability to loosen the restrictions under these rules to help increase market liquidity, which they did following September 11, 2001.

b) A negotiated private transaction. In this strategy, a company will repurchase a large block of stock from a single investor. This strategy requires a company to locate a large investor who is willing to sell.

c) A tender offer. In this strategy, a company offers to repurchase a fixed amount of stock at a single price or range of prices. This strategy allows a company to repurchase a pre-determined and substantial amount of stock in a short period. The Dutch tender offer is a form of self-tender offer.

We analyzed seven Dutch tender offers in 2002, where companies offered to repurchase their own shares ranging from 6.6% to 36.5% of the outstanding common stock prior to the tender.

Dutch Tender Offers During 2002

Company	Tender Offer Expiration Date	Announced Price Range	Price Accepted	Tender Offer as % of Outstanding Stock	Average Price 5 Days Before Expiration
DaVita Inc.	5/30/02	21.00 – 25.00	24.00	17.9%	22.52
Energizer Holdings	8/30/02	25.50 – 29.00	29.00	6.6%	28.70
Green Mountain Power	11/19/02	17.00 – 21.00	19.75	14.0%	18.91
Lone Star Steakhouse	6/14/02	20.50 – 22.50	21.38	13.4%	20.81
Maritrans Inc	1/18/02	11.00 – 12.50	11.50	19.7%	11.20
Netro Corp	8/16/02	3.50 – 4.00	3.50	36.5%	3.29
Ralcorp Holdings	12/11/02	21.00 – 24.00	24.00	13.3%	24.00

Mechanics of a Dutch Tender Offer

A Dutch tender offer operates in many ways as an auction. A company offers to repurchase a specific number of shares within a given price range. Shareholders are invited to tender shares over a 20 day period, and do so by indicating the lowest price within the range that they will accept. The company aggregates investor offers, and buys the tendered shares up to the specified share limit at the lowest price possible. All shareholders who tendered shares at the accepted price or lower will have their tender offers accepted. If the company receives more offers at the accepted price than the specified share number, all shareholders receive a pro-rata allocation.

Example:

- Issuer announces Dutch tender offer to repurchase 1,500,000 shares in the range $50-$53

- The following table illustrates submitted tenders

Tenders	Shares Tendered	Shares Accepted	Price
Investor A	250,000	0	$53.00
Investor B	500,000	483,871	$52.50
Investor C	275,000	266,129	$52.00
Investor D	150,000	145,161	$51.50
Investor E	375,000	362,903	$51.00
Investor F	50,000	48,387	$50.50
Investor G	200,000	193,548	$50.00

- The issuer repurchases 1,500,000 at $52.50.

- The issuer received 1,550,000 offers at $52.50 or lower.

- Each investor who tendered at $52.50 or lower receives $52.50/share on a pro-rata allocation of 96.8% of tendered shares.

The Dutch tender offer operates as an efficient clearing mechanism. Investors tend to want to receive the highest price possible, but risk being completely shut out of the offer if they tender their shares at the upper end of an offer. Issuers have the opportunity to amend the terms of the Dutch tender offer by changing the price range or increasing/decreasing the share amount, but doing so requires that the expiration of the offer period be extended by ten days.

Investment Opportunity

The investment opportunity begins when a company announces the start of a Dutch tender offer. Investors and, of course, arbitrageurs have the opportunity to purchase shares during the tender period and tender them to the company at the expiration of the offer.

Our analysis of a Dutch tender offer begins with the terms and history of the offer.

- In some cases, the company may have conducted a Dutch tender offer in the past, which may be informative in understanding the dynamics at play in the current offer. For example, there may have been a low number of shares tendered and the price accepted may have been at the high end of the range in a previous tender offer. This may be an indication that current shareholders will act in a similar fashion and the company would accept a price towards the high end of the range in the current offer.

- Second, we analyze the shareholder base, paying particular attention to the size of insider holdings. Insiders and certain other shareholders are much less likely to tender shares. Long-term holders may be less willing to part with their stock and participate in the offer. In addition, insiders typically announce whether they will participate in the offer in the tender offer memorandum.

- Finally, we do valuation work on the company to determine its underlying value. This allows us to evaluate our risk if our tendered shares are not accepted. We also want to understand whether current shareholders are more likely to participate in the offer or prefer to continue to hold their shares.

A Step-by-Step Case Study – Brown Forman (NYSE – BFA)

We recently participated in Brown-Forman's Dutch tender offer. Brown-Forman, based in Louisville, Kentucky, is a producer of premium spirits, wines and consumer goods. Its best known brands includes Jack Daniel's, Southern Comfort, Early Times, Fetzer, Korbel and Finlandia.

<u>Terms of the offer:</u> Brown-Forman announced on February 4, 2003 the commencement of a Dutch tender offer to repurchase 1,500,000 of Class A shares and 6,800,000 of Class B shares within a price range of $63 - $73. The offer was set to expire on March 4, 2003. Class A shares were trading at $64.90 and Class B shares $62.14 the day before the announcement. The Class A shares traded in a range of $70.81 - $72.38 during the offer. The Class B shares traded in a range of $68.60 - $71.51.

<u>Company Background and Financials:</u> Brown-Forman is a leading wine and spirits company, with expected '03 revenues of $2.38 billion. The flagship brand, Jack Daniel's, is the largest selling Tennessee Whiskey (better known as bourbon) in the US. The brand has grown its non-US volumes to represent 45% of total volumes sold versus 35% in 1995. Its consumer durable brands includes Lenox, Dansk and Hartman luggage. The company has grown EBITDA at a CAGR of 4.4% and EPS at a rate of 7.1% (not adjusting for the change in goodwill amortization) since 1995. The company is expected to earn $4.19/share in '04, representing a P/E of 16.9. The company has a long-term earnings growth rate of 9.0% per share. In addition, the company pays a dividend of $1.50 per share, equivalent to a 2.1% dividend yield.

History: Brown-Forman conducted a Dutch tender offer in 1994, offering to buy shares in the range $83 - $90 (pre-split basis). The results were informative. Class A shares were tendered at a pro-rata allocation of 98% at $90/share. Class B shares were tendered at a pro-rata allocation of 100% at $89/share. This offered a window into potential results of the current offer.

Shareholder Base: Brown Forman is a closely held company. 66.7% of class A shares and 32.4% of Class B shares are owned by insiders and family members. Brown Forman announced that it did not believe that any of these control persons would tender shares. We focused on the Class A shares, attracted by its small float. There were 28.9 million Class A shares outstanding, with a float of 9.6 million. Brown Forman was tendering for 16% of this float.

We next looked at the level of institutional ownership. Institutions owned 2.25 million Class A shares or 23.3% of the float. In contrast, institutions owned 42.7% of the float of Class B shares. The fragmented nature of the investor base and the lack of any single investor to tender for a substantial portion of the offer confirmed our focus on Class A shares. A lower number of shares tendered by others would increase the chance that we would be able to tender our shares at a high price. In addition, the Class A shares have voting privileges, trade at a premium to Class B shares, and are less liquid. Class A shares had traded at an average $1.07 premium in the 6 months before the offer. Institutions that had paid a premium to own the Class A shares may have preferred to continue to hold their shares. If these investors were to tender Class A shares, they would face a difficult task to repurchase the shares after the offer.

We also looked at the trading volume during the offer period. Arbitrage funds are typically active in Dutch tender offers, and these funds make up much of the trading volume that occurs during the offer period. There was trading volume of 394,500 Class A shares or only 26% of the 1.5 million tender amount versus 13.9 million Class B shares or 205% of the 6.8 million tender amount. Arbitrage funds seemed to be focusing on Class B shares, making us even more confident that the Class A shares were the way to go.

Results of Dutch Tender Offer: Brown-Forman announced that it had received tender offers for 470,673 Class A shares. It accepted all offers at a price of $73.00. In contrast, 11.2 million Class B shares were tendered. Brown-Forman accepted 98.05% of bids at $70.50 or below, for 7.59 million shares. Investors had the opportunity to purchase Class A shares at an average price of $71.44 in the final five days of the offer period. They would have been able to tender all the shares at $73.00 less than 1 week later, for a profit of $1.56.

Our Results: We successfully purchased Class A shares at an average cost of $71.25 prior to the expiration of the offer. We tendered our shares at $73 per share. We earned a 2.5% return on a position held for less than a week, a 128% annualized return!

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