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A $3.5b payout and nothing to show for it

Baker Hughes netted the break fee after the failed takeover by Halliburton

By Paul Harter

One of the more eye-watering figures in the business press lately was the $3.5 billion break fee payable by Halliburton to Baker Hughes as a result of its failed acquisition of the oil and gas services giant.

So, what is a break fee and how can a business be liable to pay $3.5 billion and get nothing in return? At its most simple, it is an arrangement where a target company pays a cash sum to a potential bidder if certain specified events occur that prevent the proposed transaction from proceeding … or cause it to fail. Traditionally, break fees have been more common in the context of public takeovers (i.e., where the target entity is a publicly listed company) as compared to private mergers and acquisitions (where each party is more likely to bear its own costs).

The primary rationale for a party agreeing to a break fee is that the counterparty to the transaction may be reluctant to devote the necessary resources to pursuing a transaction without a certain amount of cost protection in the event of deal failure. Other objectives include discouraging a party from leaving the negotiating table or entertaining a competing proposal and from taking other actions, or not taking actions, which may cause the transaction to fail.

Subject to any legal limitations which may apply the amount of any break fee payable will be a matter of negotiation between the parties, but, outside of the US, it is typically equal to some or all of the professional and other advisory costs incurred (or likely to be incurred) in the negotiation and due diligence stages of a deal.

Certain jurisdictions have regulated the use of break fees in public takeover situations by either prohibiting them (other than in specific circumstances) or limiting the maximum amount payable. Prior to prohibiting break fees in 2011, generally speaking, the maximum break fee payable in the UK under the Takeover Code was 1 per cent of the value of the target business.

So what about specifics of the Haliburton/Baker Hughes transaction, valued at $35 billion at the time of announcement in November 2014? First, this was actually a “reverse break-fee”. Whereas, usually, the target company agrees to pay the break fee to encourage the bidder to incur acquisition costs, here the payment was payable by the bidder to the target.

Second, at 10 per cent of deal value, the fee was larger than usual — Bloomberg cites the average break and reverse-break fee as 4-5.8 per cent of deal value, respectively, for 2014. The size of the fee in this situation reflects several factors: first reverse break-fee percentages have been increasing year-on-year since 2007-08, when a record number of deals failed. (2016 is set to break this record, however).

Second, Baker Hughes, as the target company, must have had significant leverage to command such a fee and must have required Halliburton to agree to such fee in order to be persuaded to enter into the transaction. And, third, the parties, particularly Baker Hughes, were keenly aware of the magnitude of the regulatory (antitrust) challenges facing the transaction.

Baker Hughes wanted Halliburton to fight any challenges or cooperate with the relevant regulators at all costs in order to get the deal done. And Halliburton wanted to signal to regulators that it was willing to spend billions of dollars to fight any adverse decision.

Agreeing to the payment of such a large fee suggests that Halliburton was concerned about, but misjudged the regulatory risks. In the end, the US Department of Justice filed suit to block the merger in early April, citing the threat of higher prices and less innovation in the industry, resulting in Halliburton’s termination of the transaction less than a month later.

One wonders whether Halliburton would have been so quick to terminate the transaction and pay the break fee if the oil and gas industry, and stock prices of companies in the sector, had not suffered so badly in the period since the deal was announced (this was alluded to by Halliburton's CEO on the Q1-16 earning's call).

The price of oil was around $80 per barrel on announcement and had dropped to around $45 by the time the transaction was terminated. When it was announced, the stock of Baker Hughes was valued at $78.62 per share but by the time the transaction was terminated it was around $47 only.

So what now for Baker Hughes, and how will it use the money it received? Well, its shares closed up about 1 per cent on the Friday following the deal terminating and it said that it would buy back shares totalling $1.5 billion and debt totalling $1 billion, according to a press release.

As a salutary lesson, however, the stock price continues to struggle following payment of the break fee, showing that even a one-off windfall cannot hide investor concerns as regards the oil and gas services market generally. A fact which many readers based in the region will be all too familiar with.

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