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Effect Of Mergers And Acquisitions On Stockholders And The Economy

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EFFECT OF MERGERS AND ACQUISITIONS

ON STOCKHOLDERS AND

THE ECONOMY

by

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This independent study submitted by Timothy J. Parker in partial fulfillment of the requirements for the Degree of Master of Business Administration from the University of North Dakota is hereby approved by the Faculty Advisor under whom the work has been done. This independent study meets the standards for appearance and conforms to the style and format requirements of the Graduate School of the University of North Dakota.

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TABLE OF CONTENTS

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I wish to extend my gratitude to the faculty and staff of the University of North Dakota Graduate Center, Minot Air Force Base. In addition, I want to thank my parents, James and Carol Parker, for their support in all my pursuits throughout my life ultimately leading to this independent study.

ABSTRACT

EFFECT OF MERGERS AND ACQUISITIONS
ON STOCKHOLDERS AND THE ECONOMY

Timothy J. Parker, M.B.A.

The University of North Dakota Graduate Center, 1989
Faculty Advisor: Dr. Orville Goulet

The size and volume of takeover activity has increased astronomically since the frenzy of current takeover activity began with the 1974 raid on ESB, Inc. in Philadelphia. Since then we have witnessed the growth of the raider financing tool: the junk bond. This high-yield but incredibly risky bond has helped finance some of the largest mergers and acquisitions in history. The risk has not driven away investors looking for substantial fast earnings. The demand for these so called below-investment-grade bonds continues to grow.

Are these bonds causing companies to take on too much debt to finance takeovers? Does this frenzy of takeover activity do more harm than good to shareholders, employees, the capital markets, and the economy as a whole?

From the research I have done, I have determined that there are no hard and fast rules to provide the answer to these questions. There is little concrete proof that mergers and acquisitions are good or bad. Some mergers and acquisitions will be beneficial, others will not. To find the answer, you must evaluate the effects on a company by company basis.

CHAPTER I

INTRODUCTION

State laws usually recommend the conditions and procedures under which mergers of domestic and foreign corporations are carried out. Because of the high stakes involved, mergers and acquisitions are as commonplace or more today as they were in 1914 when major antitrust legislation was passed by Congress. This is primarily due to the relaxed attitude of the Reagan administration dictating more of a hands-off policy letting the market decide whether a company should continue to live and grow independently or be swallowed whole. But the argument continues as to whether or not these expensive methods of growth actually benefit the stakeholders involved, the associated capital markets, or the United States economy in general.

There are several requirements for issuance of a final certificate of merger. They include: ratification by a specified minimum proportion of stockholders (majority or other ratio depending on the state) at a special meeting of stockholders called to act on a proposal of merger, filing articles of merger with the required state agency (usually the office of the state's secretary of state) along with required franchise taxes and fees, and compliance with provisions of the state law. State laws usually state that stockholders dissenting with the merger may be entitled to receive in cash the fair value of their shares.[1]

When the state issues the certificate of merger, the acquiring corporation is entitled to all the assets and rights of the acquired corporation. But also, the corporation is liable for its debts, claims, and other liabilities. State laws make special provision for the procedures involved in the banking and insurance laws governing certain types of institutions. These institutions include: state-chartered banks, trust companies, and insurance companies.[2]

Motivations for mergers include growth strategies such as providing additional capacity, diversification of products, backward integration, forward integration, and moving into new markets. A special kind of motive previously undertaken by companies, the acquisition of tax-loss corporations by profit-making companies in order to reduce their tax liability, is now restricted by the new tax laws.[3]

In recent years, corporations with market prices frequently falling below fair values have stimulated takeover activity. Because of the growing costs of

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[1]Encyclopedia of Banking and Finance, Eighth ed., s.v. "Merger," by Glenn Munn and F.L. Garcia.

[2]Ibid.

[3]Ibid.

expansion, it is much more economical to acquire these firms rather than spend the money to expand and build extra capacity. Under the Security Exchange Commission (SEC) rules, any acquisition of voting stock of 5 % or more must be reported to the SEC. A frequently used tactic to increase holdings of the takeover candidate is through a tender offer, which is aimed at stockholders of the targeted firm. The acquiring firm offers to pay a premium over the current market price for a specified period of time and for a maximum total of shares accepted at the tender offer's price.[4]

Whether or not specific mergers are in violation of the antitrust laws is a question of fact and law. Under the Clayton Act of 1914, the Federal Trade Commission has concurrent jurisdiction with the Department of Justice regarding enforcement of, prohibition of, monopolistic devices. Under the Federal Trade Commission Act of 1914, the commission also has jurisdiction over unfair methods of competition.[5]

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[4]Ibid.

[5]Ibid.

CHAPTER II

BACKGROUND INFORMATION

It is possible to combine two companies and their operations so that the resulting company is better able to produce the goods and services that society desires and society will benefit. Society will reward such a combination by increasing the market value of the combined company above that of the individual companies by an amount which reflects the improved ability to profitably satisfy society's needs. This value is the stand-alone value of each individual company plus the value-added from the merger. The ceiling price that should be paid for a target target company is its stand-alone value plus the full amount of the value-added by the combination of the two companies. The buyer would need to pay less than this if its shareholders are to gain and share in the extra value created by the merger.[6]

Thus, when one company is considering buying or selling another, two things should be known. First, the company should know the market value of the selling company and how accurately this value measures its underlying value. Second, the company should know if combining the two companies will result in a favorable interaction with a

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[6]Thomas Hopkins, Mergers, Acquisitions, and Divestitures (Homewood, Illinois: Dow Jones-Irwin, 1983), p. 3.

profitable value-added.[7]

In its most basic form, the market value of a company is the price at which the company can be sold. A key question is how accurately the company's shares are valued by the market. If the shares are undervalued, there is a good chance of buying the company at a bargain price. If the shares are overvalued, the company could be sold at bonus price. The price of a company's shares will be correct at any moment if the market for those shares has three attributes: it knows all information about the company; it acts on that information; and it is accurate in its assessment of the true importance of the information. Unfortunately, it is very difficult to have timing accurate enough to meet all of these requirements at one time.[8]

Another factor in determining postmerger worth is the value-added or the value that the market places on the improved ability of the combined company to profitably produce the goods and services that society demands. The value-added equals the benefits less the costs that result from combining the two companies.[9]

The decision rule to guide management in determining whether or not the company should buy another is to buy if

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[7]Ibid.

[8]Ibid., p. 4.

[9]Ibid., p. 11.

the value-added exceeds the price premium. The price premium is the excess to be paid above the stand-alone value of the selling company. The value-added less the price premium is a measure of how much better off the buying shareholders would be if the purchase is consummated.[10]

An acquisition can result in one of four situations for the buying shareholders. These are:

> (1) a win/win scenario in which a company makes a bargain-priced acquisition and is able to develop value-added; (2) a win scenario where the value-added exceeds the price premium, which can be achieved through either the pursuit of value-added or the pursuit of bargains; (3) a lose scenario in which the value-added is less than the premium; or (4) a lose/lose scenario in which the buyer and its shareholders have lost by the premium plus the value-added lost.[11]

Small companies have an opportunity for outstanding growth by acquisitions. They are likely to have large gains because small companies typically acquire other small companies that are closely held and are therefore more likely to be bargains. They are not as constrained by antitrust laws, and therefore can buy competitors generating significant value-added. For these reasons, a small company should consider an aggressive acquisition strategy as a growth strategy. On the other hand, the majority of acquisitions by large companies are detrimental to their

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[10]Ibid., p. 33.

[11]Ibid., p. 107.

shareholders. When one large company acquires another large company, it will most likely have to pay a high premium, but will not have much of a chance to generate significant value-added. This is usually because the companies are too dissimilar and if they were sufficiently similar the anti-trust laws would not allow the merger. A large company has two possibilities of winning: (1) operate on a small scale seeking value-added by acquiring product lines to add to its own or (2) seeking closely held companies at bargain prices.[12]

Selling shareholders almost always win. If a company is publicly traded, the value of its stock can be openly observed. Therefore, the shareholders are almost certain to receive a premium above this. Even if the shareholders of a closely held company do not receive a premium above the company's value, there are often additional benefits to the sellers that makes it worthwhile to sell at a lower price. For this reason, the sellers might still win despite what might appear to be a bargain price. But the selling share-holders can still lose in several ways. The company may be unaware of its value, or it may be underrepresented during negotiations leading to a bargain price for the buying company.[13]

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[12]Ibid., p. 108.

[13]Ibid., p. 109.

CHAPTER III

BENEFITS TO SHAREHOLDERS

The focus of Corporate America is changing rapidly. This change has been brought on in part by increased shareholder activism. The nation's 42 million stockholders are waking up to the fact that they have rights as owners of the companies in which they invest. But shareholder activism has led to a movement by managements to insulate them from potential takeovers. Over the past year, there has been more congressional interest in merger and acquisition activity than ever before. Numerous groups, such as the Business Roundtable composed of the CEO's of the 200 largest corporations in the United States, have come forward supporting antitakeover legislation, even though evidence supplied by the SEC shows that takeovers benefit the stockholder. At the same time, new entrenchment devices are being introduced by managements across the country.[14]

The concern being expressed is that merger and acquisition activity is bad. But a recent study by Michael Jensen in the Harvard Business Review showed that on the average, shareholders gain 30 % on their investment from a takeover. The controversy is not being stirred by the stockholder, but by managements who have forgotten who they

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[14]T.B. Pickens, Jr., "Shareholders: The Forgotten People," Journal of Business Strategy, 6 (Summer 1985): 4.

work for and what their primary responsibility is. U.S. executives are not looking at takeovers as a means of enhancing shareholder value. They only look at takeovers as a threat to their salaries and their perquisites. This is usually because they own very little stock in their own companies. As a result, executives worried about losing their jobs have adopted some questionable practices.[15]

Greenmail is an example of a questionable practice in which an investor takes a position in a company and threatens a takeover unless management repurchases the investor's stock at a premium-to-market price. The problem is that the offer is not made to all other stockholders. All management has to do to stop a potential greenmailer is say no. Unfortunately many managements are not strong enough to say no, so legislation is necessary. Greenmail is totally unacceptable and unfair to shareholders. It is a device that allows management to keep its job while relieving itself of a perceived problem.[16]

That is how most other entrenchment devices work as well. The poison pill is another example of an entrenchment device which makes a firm much more expensive for an acquiring company to purchase. To make itself less attractive .the target firm adopts a provision to issue a new class

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[15]Ibid.

[16]Ibid., p. 5.

of stock if a potential acquiror accumulates a certain percentage of its outstanding shares. This forces the acquiring company to pay twice as much to control the company, and the stockholders lose the opportunity of seeing a tender offer.[17]

Current legislative activity continues to emphasize managements efforts to entrench itself. This kind of legislation is destructive to the free enterprise system and must be stopped. Managements are moving very fast to cover themselves and shareholders must speak out to get the maximum value from their investments.[18]

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[17]Ibid.

[18]Ibid.

CHAPTER IV

WHO REALLY BENEFITS FROM TAKEOVERS?

Takeover attempts have been led by a small group of raiders who have threatened the long-term existence of even the largest corporations in this country. Making money is obviously one of the goals in taking over a company, and the raiders have made plenty of it over the years. Advocates of takeover activity will continually cite the benefits to the shareholders since they too can make a quick and considerable profit. They state that takeovers are effective methods of controlling selfish or complacent management and of bringing about necessary changes in an organization. How true are these assertions? Do stockholders really benefit from takeovers? Does the threat of a takeover really keep management on its toes?[19]

One of the most common arguments presented in favor of corporate takeovers is that the subsequent increases in stock prices following a takeover attempt benefits all the shareholders of the target company. Stock prices often actually increase substantially as a result of rumor of a takeover or an actual takeover attempt, but this increase is often not linked to added economic value. The ultimate goal of strategic decisions made by managers of a company should

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[19]Ali Malekzadeh and Afsaneh Nahavandi, "Merger Mania: Who Wins? Who Loses?" Journal of Business Strategy 8 (Summer 1987): 76.

be to increase the long-term economic value of the organization so that shareholders can earn long-term benefits. Unfortunately when faced with takeover threats, managers will be pushed to make decisions that will enhance short-term rather than long-term returns.[20]

Most of the millions of individual stockholders have invested in corporations for two reasons: (1) to benefit from their investment by receiving dividends as well as higher returns when and if they sell their stock and (2) to provide the firms with necessary capital to improve their operations and grow. Takeover tactics that burden corporations with unnecessary debt are usually not looked on very favorably by the long-term investor. On the other hand, short-term investors have no intention of holding their stock any longer than necessary. These investors are broken down into two groups with different tactics. One group is made up of the institutional investors who are required to maximize the returns of the investments of a pension fund, for example, and trade their stocks as soon as there is any movement in the market. The second group is the corporate raiders, who not only hold a certain stock for a short period of time but also actively seek to raise its price.[21]

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[20]Ibid.

[21]Ibid.

If allowed to take over a company, the raiders are likely to sell the most productive assets of the firm to pay off the takeover debt and then auction off the remaining assets to recover their investments. As a result, a reputable company with many years of productive service is cut to pieces, its managers are fired, and usually no other shareholders other than the raiders will benefit from the takeover. Managements are caught in a dilemma. If they attempt long-term planning and investment, the firm may become an attractive takeover target. On the other hand, if managements attempt short-term stock value maximization tactics to protect the firm from takeover threats, they may jeopardize the long-term existence of the corporation.[22]

Many suggest that takeover threats will help remind managers for whom they work, the shareholders. Thus, the use of takeovers is advocated as a way of controlling the entrenched, selfish company executives and of making them more effective. This argument is wrong. Though some self-interested managers do exist in companies today, they are by no means the majority. Furthermore, threatening managers with the loss of their jobs does not make them more effective. This leads to anxiety and poor performance rather than increased effectiveness. Most experts agree that the recent increase in mergers has led to a rising

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[22]Ibid., p. 78.

turnover rate and declining productivity among managers.[23]

Corporations grow either through internal development of new products or through acquisition of existing firms. Diversification through acquisitions can lead to a number of possible benefits for both parties. An effective merger can allow both firms to achieve a synergy that benefits their shareholders, their customers, and society. Managers often prefer acquisitions to internal development of products, since purchasing a company can quickly provide the firm with the needed resources.[24]

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[23]Ibid.

[24]Ibid., p. 79.

CHAPTER V

CONGRESS GETS INVOLVED

Corporate raiders threaten the vitality of the nation's economy. In response to their actions, Congress launched a counterattack beginning in September 1987 when the Senate Banking Committee approved a measure to curb abuses in the capital markets of the U.S.[25]

The growth of takeovers can be traced back to the 1974 raid on ESB, Inc. in Philadelphia. In the first six years since then, many of the targets were medium-sized companies. When the Reagan administration took control of the Justice Department and relaxed control of antitrust, the deals grew larger. From 1979 to 1982 alone, 21 of the 25 largest deals in history were forged. In 1986, nine of the ten largest deals were witnessed. The money spent on takeovers in 1986 totaled $177 billion which for the first time in history was more than the total U.S. investment in new plants and equipment. In addition, in 1986 takeovers led to the sales of $263 billion worth of debt by American corporations which was double the 1985 figure and five times the level of 1982.[26]

The trend worries some economists such as John Kenneth

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[25]William Proxmire, "Raiding American Wealth," Management Review 77 (January 1988): 57.

[26]Ibid.

Gailbraith. In a recent article entitled "The 1929 Parallel", he writes:

> The end for those in the present play will come when either recession or a tight-money crunch to arrest inflation makes the debt load they have so confidently created no longer tolerable. Then, there will be threats of default and bankruptcy, a drastic contraction in operations.[27]

The threat of takeovers has forced managers to focus completely on the short term because any weakness in stock prices will be exploited by the raiders. This causes long-term plans for growth which require investment to be set aside. Look at the case of Borg-Warner Corporation, a Chicago company that was raided by a group backed by Merrill Lynch. Its fight to fend off the group of raiders led Borg-Warner to sell its previously successful chemical division, reduce its research budget, and cut back on jobs. The company eventually won, but at what cost? The company's debt increased nearly ten-fold from $440 million in 1986 to $4.2 billion in 1987. This incredible debt load turned Borg-Warner from a highly profitable firm to "bait for loan sharks".[28]

T. Boone Pickens claims to represent the people's interests. Yet, his takeover attempt of Phillips Petroleum caused 3,400 employees to be laid off, and he walked away from the deal with $90 million in profits that some call

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[27]Ibid.

[28]Ibid., p. 58.

greenmail.[29]

While hostile takeovers can be a healthy method of removing inefficient management, the game played by many raiders with our current securities laws also exploits well-run companies. According to studies by Columbia University professor Louis Lowenstein, target firms have performed as well, and in many cases, better than their peers before raiders enter the picture. Furthermore, target firms performed worse after a successful hostile takeover. The raiders do not want to run the corporations they take over. They play with the securities laws by increasing a stock price at the expense of employees, research and development, bondholders, and the economy at large.[30]

A forceful case can be presented that raiders lead to entrenched management rather than removing it. In defense, some managers actually "scorch their own fields". Even if the raiders do take control, they will have a firm so swamped with debt that no one else would want it. To correct these abuses, the Senate Banking Committee approved a measure that will improve disclosure so that raiders are unable to manipulate the market for corporate control. What are the chances that Congress will successfully reform securities law? The first step taken by the Senate Banking

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[29]Ibid.

[30]Ibid., p. 59.

Committee is encouraging. Many in the Reagan administration feared that Congress could not legislate capital market reform without unnecessarily restricting these markets. Of course raiders will complain that Congress should not interfere in their business. In addition, opponents of this type of legislation warn that the discipline that hostile takeovers instill in management will be lost. But imagine a nation where managers do not have to worry about takeovers, and are not afraid to make long-term investments at great cost to the immediate dividends that they can pay shareholders. "There is such a country now. It is Japan."[31]

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[31] Ibid.

CHAPTER VI

STUDY ON EFFECT OF TAKEOVERS ON SHAREHOLDERS

Contemporary literature downplays the fact that the target firm shareholders and their management can have the same conflicts of interest as acquiring firm shareholders and their management. In addition, acquiring firm shareholders can lose even in a properly functioning market for corporate control. Simply advocating a free market for corporate control is not enough to protect the interests of shareholders. A stronger set of internal checks is required to govern the responsibility of management. Corporate boards that are more responsive to the needs of the shareholder are required to counter the actions of management.[92]

Firms must devote part of their resources to increase management privileges rather than maximize profit. Therefore, they will not be operating efficiently and lead to a low stock value in the securities market. Undervalued shares invite takeover attempts because outsiders realize the gains that can be made by expelling inefficient, entrenched management. Replacing these managers with executives that are more willing to maximize profits will supposedly improve the value of the firms' shares in the

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[92]Stephen Vogt and Murray Weidenbaum, "Takeovers and Stockholders: Winners and Losers," _California Management Review_ 29 (Summer 1987): 158.

market. In this view, corporate takeovers provide economic gains and in efficient capital markets, the increased profitability implies increased shareholder wealth.[33]

In a survey of ten takeover studies virtually all studies report positive abnormal returns to acquiring firms in the weeks or months prior to the actual announcement of the merger. This is the factual basis from which the prominent literature of today concludes that shareholders of the acquiring firm benefit from mergers. But that is not the end of the story. Only two of the ten studies show significantly positive returns around the date of the announcement; four report insignificant gains or losses around the date of the announcement; and three report significant decreases in the returns of the bidding companies. Of even greater interest is the fact that nine of the ten studies reported losses in shareholder returns during the period following the announcement of the merger.[34]

Because most acquisitions involve a larger firm acquiring a smaller one, the measured returns to the bidding company will be biased downward simply due to the size factor. This concern can be taken into account by using estimated abnormal dollar returns rather than abnormal

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[33]Ibid.

[34]Ibid., p. 159.

returns per share. In a survey of five additional takeover studies under these criteria, the results are not very different. Only one study shows evidence of positive dollar gains to shareholders of acquiring firms, while the other four show negative returns. Some suggest that the tendency for the lack of positive returns in acquiring firm stock is because the market "capitalizes the gains to acquiring firms at the time they announce a takeover". Individual acquisition announcements have very little effect on the stock market because they have already been discounted.[35]

Regardless of the limited ability of the market for corporate control to monitor manager activity, shareholders can always reject a possible merger by voting as a group to disapprove it. Several explanations have been presented to explain why shareholders may approve actions that are detrimental to their interests. The most realistic is that information and transaction costs required to reject the action may be too large to be worth pursuing. Managers may also have an advantage in a merger situation. Even though stock prices may have fallen upon the announcement of a merger, managers may convince shareholders that they have special information that the market has not taken into account. To the extent that shareholders trust management, they will be more likely to give the decision the go

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[35]Ibid.

ahead.[36]

A corporation's board of directors has a legal responsibility to act in the best interest of the shareholders they represent. High transaction costs in the market for corporate control and high information costs to shareholders limit the degree to which the activities of management can be monitored. Therefore, the board of directors must assume the responsibility of doing so.[37]

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[36]Ibid., p. 166.

[37]Ibid.

CHAPTER VII

THE USE OF JUNK BONDS TO FINANCE TAKEOVERS

There appears to be no end to the wave of takeovers that has flooded in the U.S. in the past few years. In addition, according to the investment bank Morgan Stanley, hostile raiders were enjoying a 50 % success rate in 1985 compared to a 20 % rate in previous years. Increased success has definitely added to the flood. Companies and raiders are encouraged by a strong stock market that often bids up the price of the stock of the acquiring company as well as that of the target company. But none of this activity would have been possible without the money being available to finance the takeovers. The money continues to be available because the investors are still willing to buy the junk bonds used by the raiders to raise funds.[38]

Despite the negative label, investors appear to be happy owning the below-investment-grade bonds. In 1986, junk issues still offered a coupon of 12 %, compared with a yield of 7.6 % on long-term Treasury bonds. Most investors who bought the early junk bonds have earned substantial profits, enjoying higher coupons than most investments plus the rising capital values produced by falling interest rates.. Though a few junk bonds have lost heavily, most have

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[38]"Wall Street's Junkies Are Hooked on Takeovers," The Economist, 15 November 1986, p. 93.

disproved their negative label.[39]

Institutional investors see junk bonds as very much like equity with a coupon attached rather than as an ordinary bond. The risks are higher than on standard corporate bonds. They are more of a bet on a company's ability to pay off its debt rather than on interest rate trends. Prudential carried out a study that indicated that returns on high-yield bonds are at their best during a recession.[40]

Much more risky than junk bonds is the growing willingness of investment banks to bet their own capital on takeovers by arranging bridge financing and profiting from the spread between the cost of funds and the loan interest. Investment bankers are doing this for at least three reasons. First, to fight against Drexel Burnham's dominance of takeover finance, by offering bidders up-front financing. Second, it is a way to persuade clients to drop old relationships with other banks and to hire a new bank as advisor on a deal. Third, the potential profits from such investments are quite large.[41]

Short of counterproductive restructuring, the defenses available for vulnerable firms look increasingly bare.

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[39]Ibid.

[40]Ibid.

[41]Ibid., p. 94.

Takeover fever continues to spread as Wall Street's investment banks begin to look outside America to apply their tested techniques. This is probably why Drexel Burnham has held a seminar on junk bonds in Japan.[42]

Starting in 1984, Drexel pioneered the use of junk bonds to help finance takeovers, particularly hostile ones that commercial banks and traditional investment firms had tended to stay away from. With Drexel providing advice along with the financing, the raiders appeared to be invincible. Now due to Drexel's close relationship with Ivan Boesky and the charges against Michael Milken, Drexel is a "bleeding shark" with a severely damaged reputation and potentially reduced dominance in the junk bond market.[43]

If Drexel's role in the junk bond market were to be reduced, the overall junk bond market would be reduced until competitors moved in to take up the slack. In reality, Drexel's dominance was slightly reduced for a short time and competitors moved in very quickly so that there was a barely noticeable change in the total junk bond market. A smaller junk bond market was expected to reduce the market for other kinds of credit for a short time as well. In many cases leveraged buyouts or stock raids are only partly financed by

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[42]Ibid.

[43]Ford Worthy, "Wall Street's Spreading Scandal," Fortune, 22 December 1986, p. 27.

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[42] Ibid.

[43] Ford Worthy, "Wall Street's Spreading Scandal," Fortune, 22 December 1986, p. 27.

junk bonds, which supplement other kinds of debt. Therefore, if the supply of junk bonds declined, bankers were likely to be more stingy with their own loans.[44]

The broad reappraisal currently underway brings into question the role that arbitragers (arbs) play in takeover battles. Honest arbs fulfill a useful function by ironing out differences in the prices of stocks, options, futures, and interest rates to make the financial markets more efficient. But arbs play a different role in takeovers. Once an offer or even a rumor of an offer is made, they bet on the outcome. If they buy the target company's stock, they will get stuck with a loss if the deal falls apart. Meanwhile, they have added liquidity to the market by enabling stockholders uncomfortable with the uncertainty to bail out at a higher price.[45]

Senator William Proxmire, chairman of the Senate Banking Committee at the time, wanted to slow down the arbs. He was considering a proposal that would redefine when a shareholder becomes an actual shareholder with all rights due to him. In the event of a hostile tender offer, only those who owned the stock at least 30 days prior to the formal offer would be entitled to have their shares counted. Proxmire believes that hostile bids should require the

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[44]Ibid., p. 28.

[45]Ibid.

approval of two-thirds of all shares rather than a simple majority. But writing legislation affecting takeovers is very difficult and is not made easier by the conflicting ideas of various business lobbies.[46]

Harold Simmons, raider of NL Industries, would be happy with no arbs at all. "They force prices to go higher than they otherwise would." Another anonymous raider has a different view: "Arbs grease the skids. They make the target company a little more nervous. You'll still do the deal without them, but it might be slower going."[47]

Even before the Boesky affair came into the public eye, the SEC was trying to take the advantage of the sneak attack away from the raiders. Under the present rules investors must file notice with the SEC as soon as they accumulate more than 5 % of a company's stock. But they have a ten-day grace period to file notice. During this period a raider or investor can continue to buy stock so that by the time he files he has 10 % or more of the company's stock. Meanwhile, arbs smelling signs of a takeover may start buying stock as well. Therefore, by the time the management of the company understands who is buying its stock or why someone is buying it, it may be too late to defend

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[46]Ibid.

[47]Ibid., p. 29.

itself.[48]

The SEC hopes that Congress will require that such filings be made within two days which would significantly affect raiders out to greenmail a company. This is because they would not be able to accumulate as much low-priced stock before eager investors catch on to the possible take-over and bid up the price.[49]

Despite the insider trading scandals, powerful profit-seeking raiders will continue to deal, and investment banks are still more than willing to provide the funds. In addition, investors, many of them the pension and profit-sharing funds of major U.S. corporations, continue to favor junk bonds over high-grade bonds that yield less.[50]

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[48]Ibid.

[49]Ibid.

[50]Ibid.

CHAPTER VIII

EFFECTS ON THE ECONOMY

Leigh Trevor, the president of Stakeholders of America, reports that between March 1985 and January 1988 there have been 140 hostile takeovers to attempt to gain control of major U.S. companies. These takeovers involved $100 million each, sometimes a great deal more. What have these takeovers accomplished? Basically, they have significantly increased the wealth of the hostile raiders. They have definitely not created jobs. As a matter of fact, at just seven companies including Phillips Petroleum Company, Chevron-Gulf Corporation, Unisys, Goodyear Tire & Rubber, Union Carbide Corporation, and American Hospital Supply nearly 80,000 jobs were lost in just 30 months. In addition, several small towns which housed factories or plants owned by these firms were devastated by the layoffs and in some cases plant closings.[51]

Job loss is one detrimental effect of takeovers. The devastating effect on communities is another, and the loss of research and development funds is yet another harmful effect. Owens-Corning, Goodyear, and other companies have cut back their research and development facilities. One of America's most significant hallmarks in the world of

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[51]John B. Schwemm, "The Corporate Killing Fields," Management Review, 77 (January 1988): 55.

business has been successful innovation. Innovation today requires substantial long-term investment in research and development. But according to Robert P. Luciano, chairman and CEO of Schering-Plough Corporation,

> The current takeover atmosphere encourages corporations to think defensively, to minimize R & D expenditures that aren't immediately profitable, and to maximize profits today because tomorrow may never come.[52]

Also, pension funds are substantially depleted to reduce the debt accumulated to make a raid, and pension funds are reduced by managements to lessen the chance of a takeover. If raiders decide to remove retiree health plans because of their expense, how will society handle the costs for those retiring in the future?[53]

The Ivan Boesky case showed that, rather than being freed, the market is being rigged by those trying to make a fast buck. The organization, Stakeholders of America, desires several changes in federal law governing takeovers. First of all, at least 60 business days should be required between the introduction and conclusion of a hostile takeover. The present 20-business-day period is much too short for investors to evaluate the relevant economic information and get in on the action if they want to. Second, disclosure should be required to be made stating the

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[52] Ibid., p. 56.

[53] Ibid.

value when the company takes on more debt.[55]

According to critics, so far the restructuring is a "zero-sum game" in which someone gains only when someone else losses. On an economy-wide basis they may have a point. According to Michael Drury of A. Gary Shilling & Co., an economic consulting firm in New York, the real net worth of the U.S. economy fell 0.8 % in 1985. This is mainly due to the drop in values in oil and agriculture industries. The stock market increased its real value, but this did not lead to a gain for the economy as a whole. In addition, according to Edward S. Hyman, Jr. of Cyrus J. Lawrence Inc., takeovers led to a 0.5 % to 1 % decrease in GNP in 1985 due to the reductions in company size and the loss of jobs.[56]

Looking at several companies and how they are currently running shows restructuring can lead to economic improvement despite the cost to society. John D. Paulus, Morgan Stanley's chief economist, observed that industries and services with a higher-than-average amount of restructuring had seen a significant jump in productivity.[57]

A rapidly changing world has required U.S. business to

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[55]Joan Berger, Norman Jonas, and Karen Pennar, "Do All These Deals Help or Hur the U.S. Economy?", Business Week, 17 November 1986, p. 86.

[56]Ibid., p. 87.

[57]Myron Magnet, "Restructuring Really Works," Fortune, 2 March 1987, p. 38.

change with it. Post World War II success led the U.S. into a slumber caused by huge, sluggish, complacent corporations while the Japanese marched on by. Restructuring is reducing the enterprise-stifling bureaucracy, policies, and administrative costs that led to this problem.[58]

Overly large companies caused two major problems, one financial and one competitive. On the financial side, subsidiaries performing below the level of the rest of a company were reducing or, at best, not adding anything to the value of the company's stock. Even worse, some acquisitions with strong earnings ended up reducing the value of the company while still providing per-share earnings growth. This happened because corporations were paying too much for acquisitions due to bidding wars, induced by profit-hungry investment banks. In addition, the rapidly rising cost of capital of the seventies made companies earn less on their acquisitions than what the capital tied up in them cost. As a result, managers watched their acquisitions reduce the overall value of the company.[59]

The competitive problem is the more pressing of the two, threatening the long-term economic prosperity of the nation. Today foreign competitors are making their presence known in a big way creating gluts in market after market. The U.S.

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[58]Ibid., p. 39.

[59]Ibid., p. 40.

share of the world's total output dropped from 42 % in 1962 to 25 % in 1980. The present state of affairs is illustrated by the statement:

> Those much-lauded corporate cultures, those peaceful communities flourishing under the paternalistic mill's beneficent smokestacks - alas they are dysfunctional. They are not cutting the mustard in international trade, and their accompanying conviction of moral rightness is not enough to sustain them in the face of new realities.[60]

Corporate raiders like T. Boone Pickens Jr. and Sir James Goldsmith began the restructuring that would provide a solution. Take as an example the oil companies of the Seventies and early Eighties. They had more cash than they knew what to do with. Rather than returning the cash to shareholders to reinvest, managements proceeded to squander it on unproductive acquisitions and wells so expensive to drill that they could not make a profit from them. So Pickens went after Gulf and forced management to restructure. Chevron ended up with Gulf, and Pickens accomplished what he set out to do. Gulf shareholders earned $13.3 billion, and the high cost of the deal prevented Chevron from drilling unproductive wells.[61]

Unocal and Phillips Petroleum later fought Pickens off, but again were forced to restructure like Pickens wanted them to. $8.7 billion was paid to shareholders, and the

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[60]Ibid.

[61]Ibid.

companies were unable to expand further due to the huge debt accumulated to fight off Pickens. Other oil companies restructured on their own before Pickens could come after them.[62]

Break-up takeovers work on the principle that you can buy a company in the stock market for less than you can get for selling off the separate businesses. Losing businesses, which lower the value of a company's stock, can be profitable for anyone willing to restore them to the state they were in before the acquiring conglomerate messed them up.[63]

Sir James Goldsmith is most well-known recently for his unsuccessful takeover attempt of Goodyear. However, he was successful in taking over and breaking apart two overly large forest products companies, Diamond International in 1982 and Crown Zellerbach in 1985.[64]

As its traditional match business dropped off during the Sixties, Diamond International's management began to acquire smaller companies at an alarming rate for the next ten years. Goldsmith began buying the company's stock in 1978. After angrily watching another useless acquisition and $400 million in unproductive capital improvements go

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[62]Ibid.

[63]Ibid., p. 41.

[64]Ibid.

down the drain, he had enough and by 1982 had acquired the company. Then, he began taking it apart.[65]

United States Playing Card Co., used by Diamond as a cash cow for a dozen years, was sold to its management in 1983. The company invested to automate its production line and acquire competitors. By 1986, the company was making a $700,000 profit. Due to a changed management salary structure, previously unthinkable under Diamond's bureaucratic structure, Heeking Can Co. has increased its sales 40 % and profits almost 50 % since Wesray bought it as a leveraged buyout (LBO) in 1982.[66]

After acquiring Crown Zellerbach, Goldsmith spun off its core paper operations to James River Corp. James Rivers had previously bought most of Diamond International's paper business from Goldsmith as well as the paper division sold by American Can during its restructuring. James River has more than doubled the operating income of all three of these operations.[67]

Due to global overcapacity of some of the products it offered, Monsanto began restructuring. It sold its unprof-itable commodity petrochemical businesses in 1980, reducing it from 25 % of its assets to 4 % today. Instead, it

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[65]Ibid., p. 42.

[66]Ibid.

[67]Ibid., p. 43.

concentrated on its high-value, more competitive specialty petrochemical products, such as herbicides, high-performance plastics, and nylon carpeting. Since October 1985, Monsanto's stock price has almost doubled.[68]

How should you restructure? Think like a raider when looking for what to keep and what to get rid of. Westinghouse Electric has done this and was rewarded with a 20 % return on equity and a 370 % stock price gain since 1982. If it was not growing or at least returning 15 % to 20 % on equity, and could not be made to do so, it was discarded. This included the company's 90-year-old, profit-making lighting business.[69]

There are also a few examples of takeover threats stimulating management out of their complacent, stagnant state. Thomas G. Pownall, chairman of Martin Marietta Corp., thinks that his company has turned out better because of its 1982 battle with Bendix Corp. The battle forced Pownall to raise its debt ratio up to 80 %. Looking back now, Pownall says:

> The affect was salutary. We went through a period of reexamination, redeployment of some assets, and redirection of some of our attention. We are far stronger now as a company and have the best

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[68]Ibid., p. 44.

[69]Ibid., p. 46.

long-term prospects in our history.[70]

Walt Disney Co. has been attacked twice, and also emerged a more profitable and aggressive company. Uniroyal went private and then liquidated after a bid by Carl Icahn in 1985. Former chairman Joseph P. Flannery stated that most of their businesses will get much better treatment and have a greater chance of success than when they were under Uniroyal.[71]

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[70]Judith H. Dobrzynski, Resa W. King, Gregory L. Miles, James R. Norman, and Zachary Schiller, "More Than Ever, It's Management for the Short Term," Business Week, 24 November 1986, p. 93.

[71]Ibid.

CHAPTER IX

CONCLUSIONS AND RECOMMENDATIONS

Mergers and acquisitions are extremely complex financial transactions. They are more complex than most sources are willing to admit. A great deal more goes into determining the value of such transactions than what a congressman, stakeholder, or any other layman can understand. The majority of the sources studied were against takeovers because of their negative effects on stakeholders, the capital markets, the economy, and society as a whole. Unfortunately, it was not clear as to whether these sources were speaking from an informed, personal, or emotional standpoint.

Studies have shown that mergers do not necessarily lead to higher returns. But as illustrated in the actions of T. Boone Pickens Jr. and Sir James Goldsmith, takeovers are not necessarily carried out to earn higher returns. These gentlemen are definitely out to make money, but they are also the leaders of the restructuring of Corporate America. True, takeovers can cause people to lose their jobs, plants to close, and managers to work only toward short-term gains to defend their jobs. In addition, the exorbitant debt required to fight off raiders can devastate a previously profitable firm. However, restructuring through takeovers can also breathe new life into a company and possibly its management. Fear of takeovers is not necessarily the reason for managers to think in the short term. Greed and the desire for big money earned in the shortest possible time are other reasons for managers acting in this way.

It is apparent that restructuring is a necessary change to ensure that American companies can keep up with foreign competitors. This is a very real threat to our standing in the world economy. Our businesses must pare down to move quickly enough to stay in step with the Japanese. Raiders like T. Boone Pickens Jr. and Sir James Goldsmith have shown the way. Continued restructuring by our largest firms appears to be the one of the most effective methods of improving Corporate America's economic performance.

Congress has been pressured to increase federal legislation controlling takeover activity. Changes in disclosure requirements, grace periods, and the definition of full-fledged stock ownership will not stop the raiders. They may slow the raiders down or cause them to change their tactics. But as long as there is money to be made and restructuring to be done the raiders will not stop dealing. Increased legislation is not the answer. Leave control of corporations to the states where it belongs.

As long as the demand for junk bonds is high, firms will continue to attempt mergers and acquisitions because the money is available to finance the deals. The king of junk bonds, Drexel Burnham, was damaged by the Boesky scandal, but there are plenty of other competitors willing to take their business. However, even if junk bonds fade away there are plenty of other methods of financing for the raiders. They will find a way.

Raiders claim to be providing a way for Corporate America to grow and become profitable again. Executives say they are doing nothing but hurting the economy. There appears to be very little concrete proof for either claim. Evaluating how a merger or acquisition will affect shareholders, employees, the capital markets, and the economy should be accomplished on a company by company basis. Some mergers will be beneficial to the companies and others will not. There are no magic rules and it appears there never will be.

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