11-1987

Is Takeover Fever Jeopardizing Our Nation's Health?

Ellen B. Magenheim
Swarthmore College, emagenh1@swarthmore.edu

Recommended Citation
Ellen B. Magenheim. (1987). "Is Takeover Fever Jeopardizing Our Nation's Health?". *Forum*. 10-10, 12.
https://works.swarthmore.edu/fac-economics/421

FORUM

IS TAKEOVER FEVER JEOPARDIZING OUR NATION'S HEALTH?

by Ellen Magenheim

Although the visionaries of corporate America intermittently predict that merger mania will soon subside, every day brings an announcement of another takeover bid. Indeed, in the first half of 1987 alone, over 2,000 takeovers were announced. The frenzy continues despite tax law changes, tighter state antitakeover laws, and insider trading scandals linked to mergers and acquisitions. The question is, can our economy continue to support this buying spree?

Supporters of takeover activity argue that acquisitions, especially when hostile, are the most effective device for disciplining entrenched management and restoring the competitive spirit in corporations. This argument suggests that target firms are inferior performers. But research indicates the contrary. A study of 15 hostile takeover targets in 1982 and 1983 found that the rate of return for the targets averaged 18 percent, well above the average rate of return for all companies during that period.

There is growing evidence that as premiums for shareholders in target firms grow larger, losses to shareholders in acquiring firms are mounting.

Of course, any shareholder of a firm that has been taken over knows the pleasure of walking away with a premium of 80 percent or more over the pre-bid share price. But for shareholders in acquiring firms, takeover announcements are not always cause for celebration.

There is growing evidence that as premiums grow ever larger, losses to shareholders in acquiring firms are mounting. Research shows shareholders in acquiring firms can expect a rate of return of 5 to 16 percent *less* than projected for the first three years following a takeover. These lowered averages may amount to hundreds of millions of dollars lost for some companies. Clearly, shareholders of acquiring firms need to pay more attention to what managers are doing with shareholders' equity.

Bond holders in acquiring firms may also be hurt. These acquisitions are often debt-financed, whether through junk bonds or higher-grade bonds, leaving corporate acquirers highly leveraged. A recent study of 57 hostile takeovers from 1976 to 1983 showed that for the acquiring companies, the average debt-to-equity ratio was 52 percent before the acquisition. One year after the takeover, those companies reported debt-to-equity ratios averaging 77 percent. As a consequence, downgrading of bond ratings following mergers is becoming common. In 1986 Standard and Poors changed ratings on 513 issues; 364 were downgraded. The easy response is that holders of bonds with lower ratings are compensated with higher potential returns. But this, of course, is speculative at best. And target-firm bond holders are as vulnerable to downgradings as their counterparts in acquiring firms.

Increasing leverage and increasing institutional ownership may lead managers to make distorted decisions based on concerns for short-run performance.

A popular means of fighting off hostile takeover bids is through recapitalization. For example, three years ago Phillips Petroleum Corp., to fend off takeover attempts by both Mesa Petroleum Corp. and raider Carl Icahn, took on $4.5 billion in debt and reduced its equity base by $5 billion. Although Phillips successfully thwarted the raiders, it also became the most highly leveraged corporation in the oil industry—hardly an honor the company's bond holders would seek.

If there are so many losers, why do we still see so many takeovers? Some acquisitions are motivated by the opportunity to lower average production costs or to ensure stable sources of supplies through vertical integration; in other words, the impetus is sound business practice. And as supporters of takeovers so often point out, the immediate average loss to acquiring firm shareholders is less than the average amount target shareholders gain.

Many see increased debt from a poison-pill maneuver or a heavily leveraged acquisition as a problem limited to the companies relying on such strategies. But corporate indebtedness may have wider-reaching ramifications. The fact that recapitalizations and debt-financed acquisitions are becoming more common raises fears about macroeconomic stability as well as concerns about the futures of the corporations directly involved. What will heavily leveraged companies do during an economic downturn? If they

FORUM

are not earning enough to meet interest payments, their options—reduce real investment, raise funds by selling off profitable divisions, issue more debt to finance the existing debt, or declare bankruptcy—are not attractive ones.

Increasing leverage along with increasing institutional ownership may also lead managers to make distorted decisions based on excessive concerns for short-run performance. For example, managers of potential target companies, fearful that growing numbers of institutional shareholders might tender shares quickly, would be tempted to use strategies aimed at keeping share prices up at the expense of their organizations' long-run financial health.

The effects of this overemphasis on the present at the expense of the future are not confined to stockholders. Consider corporate investments in research and development. Undertaking a risky, long-term project is something that managers lose sleep over in the best of times. Imagine that it is not the best of times: the debt burden is heavy and the institutional shareholders are breathing down your neck. If your company's share price declines, even temporarily, you know that stockholders are ready to tender to the first bidder who offers a premium. Would you make investments in R&D then?

In the end, to suggest that the result of takeovers is a net gain for most shareholders, and therefore the economy, is simplistic. It overlooks the fact that some shareholders gain at the expense of others. It also overlooks the risks of increasing bankruptcy and unemployment rates when too many companies are highly leveraged. Without better understanding of these and other troublesome effects, the negative impact of takeover fever on our nation's economic health is simply too much to ignore. ■

Ellen Magenheim is assistant professor of economics at Swarthmore College.