

THE CAUSES AND CONSEQUENCES
OF HOSTILE TAKEOVERS

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Amarnath V. Bhide

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(ii)

ABSTRACT

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Amarnath V. Bhide

The numerous claims and counter claims that are made about the causes and consequences of hostile takeovers are not well supported by data. Critics of hostile takeovers usually cite anecdotal evidence about a few transactions, while advocates rely on "event studies" of friendly transactions. An important objective of this research was to test the assertions against the actual record of all contested tender offers in 1985 and 1986 by examining a broad range of quantitative and qualitative data.

The research suggests that many of the claims -- both pro- and con -- are not consistent with the data. In particular: 1) Hostile takeover attempts are not triggered by market irrationality; hostile acquirers are not motivated by buying "cheap" stocks. 2) Long term investment is rarely sacrificed. 3) Significant job losses do not follow hostile takeovers. 4) Good managers are not displaced. 5) Takeover debt assumed does not create a permanent high risk financial structure. 6) Hostile acquirers do not undertake takeovers with the expectation that they can manage the businesses of the target better.

The typical impetus for a hostile takeover appears to be the "arbitrage" profit that may be realized by selling off the component businesses of diversified companies, often to private firms or partnerships. Indeed there appear to be only two significant consequences of hostile takeovers: 1) Reversal of past policies of unrelated diversification. and, 2) Transfer of control of some businesses from public to private control.

The research also analyzed the value that might be added or destroyed by the two effects. The analysis suggested that splitting up diversified firms and transferring businesses to private ownership has positive economic consequences.

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INTRODUCTION

Rapacious raiders and short-sighted institutional investors, says Drucker¹, are behind the prevailing rash of unfriendly takeovers.

And "there can be absolutely no doubt", he claims, that hostile takeovers "are exceedingly bad for the economy". The record of companies that have been acquired in a hostile takeover is "uniformly dismal". Acquired companies are loaded with a "heavy debt", which "severely impairs the company's potential for economic performance." Divestitures of "the most valuable parts of the acquired businesses" that invariably follow, "impairs both their productivity and that of the remaining assets."

Drucker's views resonate throughout corporate America. The Business Roundtable, comprising the chief executives of America's 200 largest companies, complains that hostile takeovers "create no new wealth but merely shift ownership and replace equity with large amounts of debt"². Plank, the Chairman of Apache Corp., claims that "the vast majority of unfriendly acquisitions reflect strategies for short-term gain at the expense of long-term values".³ Commons⁴, former Chairman of Natomas, writes: "No doubt, some corporations have tired blood, managements that are arrogant or indolent or worse...but from my observation poorly managed corporations have not been the principal takeover targets. Most of the recent major targets have been successful, reasonably or well-managed companies..."

The Reagan administration, conservative economists, and a small number of raiders like Pickens and Goldsmith articulate a very different point of view about the causes and

1 Drucker (1986)

2 Economist 6/1/85, p73

3 Pickens (1986)

4 Commons (1986)

consequences of hostile takeovers. Contests for corporate control arise when bidders believe they can derive greater value from a corporation's assets than the incumbent management team. "In this fashion", says the President's Economic Report of 1985, "the external market for corporate control disciplines managers who believe they have maximized the value of their corporation's shares when, in fact, they have not".

The evidence indicates, continues the Report, that takeovers "improve efficiency, transfer scarce resources to higher valued uses, and stimulate effective corporate management. They also help recapitalize firms so that their financial structures are more in line with prevailing market conditions".

Patchy Evidence

The evidence that both advocates and critics of hostile takeovers can muster is somewhat patchy.

Advocates base their case on increases in stock market values. Jensen⁵ for example, estimates that gains from mergers and acquisition activity in the period 1977-86 total about \$400 billion -- \$346 billion in the form of takeover premia paid to target shareholders and about \$50 billion through the higher valuations the stock market placed on the stocks of bidders. These gains, it is argued, are a true reflection of the substantial contribution of takeovers, since the stock market is an unbiased and efficient arbiter of long-term economic value.

Now it is a commonplace that target shareholders are paid a premium price, at least relative to the market if not to their expectations when they purchased the stock.

Evidence of gains to bidders is, however, not at all clear cut.

First, "event studies" of gains to bidders (measured by estimating the "excess" returns around the time a takeover is announced) show mixed results -- some show

⁵ Jensen (1987)

positive excess returns, while others show below normal returns. Jensen's claim of small positive returns to bidders is based on "averaging" the results of several of these studies.

Second, the period from which the data is drawn raises questions about the reliability of the results. Every single study cited by Jensen and Ruback⁶ that shows positive bidder returns, uses pre 1980 data and includes the results of takeovers from the days of the "go-go conglomerates" of the 1960s -- a period during which, many reasonable people will argue, the stock market was not a particularly reliable barometer of value creation.

Third, as Roll⁷ puts it: "The interpretation of bidding firm returns is complicated by several potential measurement problems. The bid can convey contaminating information, that is, information about the bidder rather than about the takeover itself. The bid can be partially anticipated and thus result in an announcement effect smaller in absolute value than the true economic effect."

Roll argues these measurement problems are severe. "It should be noted", he writes, "that the price change after the resolution of a successful bid (either merger or tender offer) is almost uniformly negative (cf. Jensen and Ruback 1983, table 4, p. 21) and is relatively large in magnitude. This is a result that casts doubt on all estimates of bidding firm returns because it suggests the presence of substantial measurement problems."

The results of studies that have sought to measure the "aggregate net changes" in the value of bidders' and targets' stocks are also inconclusive. As Roll writes: "The available empirical evidence indicates that the measured combined value has increased in some studies and decreased in others. It has been statistically significant in none."⁸

⁶ Jensen and Ruback (1983)

⁷ Roll (1987)

⁸ Roll (1987)

Therefore we cannot rule out the possibility that gains to target shareholders come out of the hides out of the bidders'. The claim that takeovers lead to net positive changes in stock market value is at best an informed guess.

On the other hand, critics' claims that the shortsightedness of institutional investors creates opportunities for hostile takeovers are not based on any evidence whatsoever. It may be true that institutional investors are induced by their sponsors to adopt a quarter to quarter perspective. But, there is no reason why even short-term traders should discriminate against companies with "good" managers following "long-term strategies". The evidence in fact, suggests that the stock market pays a premium for long-term growth and investment opportunities.⁹

Critics may be on somewhat firmer ground in their claims about the consequences of takeovers. Most studies show that performance declines after a takeover -- returns on capital and market share drop and a high proportion of acquisitions are eventually divested¹⁰. There are virtually no studies which show that takeovers are followed by an improvement in performance.

One problem with the post-takeover profitability studies is (as we will discuss later) that they rely on accounting measures, which may not accurately reflect economic reality. A more serious problem is that the studies are of mergers in general rather than of hostile transactions in particular.

Studies of the long term consequences of unfriendly transactions are hard to come by because they are of recent vintage, and still relatively uncommon. "Hostile raids as an established acquisition strategy originated in 1974", reports Grimm, "when Morgan Stanley & Company represented International Nickel Company of Canada in its hostile

⁹ Jensen (1986), p12

¹⁰ Ravenscraft and Scherer (1985), Porter (1987).

unsuccessful offer for ESB Inc."¹¹ The most controversial deals, launched by individuals like Goldsmith and Icahn, rather than by corporations like United Technologies have been in the vogue only since 1983. The total number of successful transactions is small - there have been only 155 successful contested tender offers since 1974 (out of 283 attempts) and only 46 successes (out of 101 attempts) since 1983. In contrast there have been thousands of successful friendly mergers *every year* during the same period.

The absence of data and accumulated knowledge on hostile transactions wouldn't matter if, as some economists claim, the only difference between friendly and unfriendly transactions is the attractiveness of the price offered and the incentives of incumbent managers to go along with the takeover. But, as I will show, there are significant differences between hostile and friendly transactions. Hence, the record of the more common friendly transactions ought not to be used to evaluate the relatively infrequent and new unfriendly deals.

Approach of the Study

This study focuses on the hostile takeovers that were attempted in 1985 and 1986, using, as control groups, friendly takeovers of the same period, and hostile takeovers from 1981.

I have refrained from trying to measure the "value created" in these transactions. Although determining the economic value created would be a very desirable objective, it is not a feasible one. A significant proportion of hostile acquirers are private individuals or partnerships; consequently, they do not have the stock trading history needed to measure "value" using the event study approach, nor are they required to make public the data necessary for a post-merger profitability study.

Instead of estimating the value created according to some absolute economic

11 Grimm (1986)

standard, therefore, I sought to analyze value created from the acquirer's point of view. What value or benefit, I sought to determine, do acquirers expect that makes them willing to go to the expense and trouble of attempting a takeover? This more modest question, I found, could in fact be tackled with the available data even on private acquirers.

The second set of questions addressed by this research relate to the near term consequences of hostile takeovers. We may or may not be able to determine the long term consequences of the post 1983 hostile takeovers in a decade or so; in the meantime it is useful to investigate claims about their immediate effects: Do they lead to "dangerous" increases in financial risk? Are they followed by shortsighted cutbacks in long-term investment? How common are "bust-up" takeovers? And do they lead to a loss in useful synergies? Is value for stockholders created at the expense of the target's employees? And, do takeovers lead to an improvement in the quality of managers who control the target organizations?

The methodology I employed was significantly different from most previous studies of takeovers. The typical econometric study tests a model for value creation -- it has one dependent variable (usually changes in stockholder wealth, sometimes profitability) and a handful of independent variables. In this study, instead of relying on any one model, I relied on scores of individual analyses to investigate the questions I was interested in. By itself, no single analysis was conclusive, but taken together, the results fell into, I believe, a clear and coherent pattern.

A second difference relates to the nature and sources of my data. In traditional studies of takeovers, quantitative data, often drawn from large public data bases such as CRISP or COMPUSTAT, is used. Several of the analyses that I used relied on "soft" variables; and, I created my own data bases, drawing on an extensive set of public sources such as SEC filings, analysts reports, news reports and stock research.

Findings: Criticisms Unfounded

The results of this research are not consistent with most of the criticisms that have been levelled against hostile takeovers.

Stock market shortsightedness or irrationality does not appear to play a major role in motivating acquirers. A majority of hostile takeovers in 1985 and 1986 were motivated by acquirers beliefs that value could be created by "restructuring" the target -- substantially changing its financial policies, cost structures, or diversification strategies. Perceived "undervaluation" of the target by the stock market was not an important consideration; and whether or not "undervaluation" was on the suitor's mind, other evidence is not consistent with claims that the shortsightedness of institutional investors leads to hostile takeovers.

Nor do the consequences appear to be dire -- hostile takeovers in 1985 and 1986:

- o *Did not lead to dangerous permanent increases in financial risk.* Although several takeovers were financed by speculative grade debt, in virtually all such cases studied, debt levels were quickly reduced by asset sales, new equity issues, or innovative refinancings.
- o *Did not choke long-term investments.* Except in two cases, the reported cuts in investment that followed the takeovers, would in all likelihood, have been made without a change in management control since extensive industry wide cuts were taking place. And, in any event, few of the targets were making substantial long-term investments before they were taken over, since most belonged to mature, low-tech industries.

- o *Were usually followed by divestitures*, especially if they had been motivated by expectations of restructuring profits. *These divestitures do not however, appear to have led to the loss of synergies*; rather they appear to be reversals of past policies of unrelated diversification.
- o *Did not lead to substantial job losses*. Takeovers were often followed by layoffs and plant closings; in over half of such cases however, the layoffs would probably have occurred without changes in control because of severe industry-wide competitive pressures -- as previously noted, targets were often found in mature or declining industries. The total number of jobs lost in the other "avoidable" cases, probably did not exceed a few thousand. The number of jobs lost "due to" hostile takeovers therefore, is a small fraction of the job losses in corporate America that have been induced by competitive pressures since the 1982 recession.
- o *Do not appear to have displaced "good managers"* -- an overwhelming percentage of the targets had poor performance records.

The contrast provided by findings from the control sample of friendly takeovers underlines why hostile takeovers should not be tarred with the same brush as friendly takeovers and suggests some reasons for the dismal findings of post (friendly) merger studies.

Perceived synergies or the advancement of some corporate "portfolio" strategy, rather than profits from "restructuring" the target, I found, were the most common benefits expected by acquirers from friendly mergers. Targets of friendly mergers were more likely to be well managed companies with attractive growth prospects. Investments and employment cutbacks, whether induced by product-market competition or otherwise,

were consequently rare. And, the top management teams of the targets were more likely to be left undisturbed.

It is not difficult to see why friendly acquisitions of "good" growth companies often prove to be disappointments and are subsequently divested: the target may be at its peak at the time of its acquisition; well intentioned efforts to realize synergies may be disruptive; and, the target's management team may lose interest along with its independence. In contrast, the poor performing targets of hostile takeovers often have no place to go but up!

The True Significance

The seemingly innocuous consequences of hostile takeovers ought to make us wonder about whether they produce the benefits claimed for them. If not many eggs are being broken, what kind of omelette do we have on our hands? If raiders are not shutting down plants, laying off workers, or imposing the discipline of high leverage¹², how, after substantial premiums to target shareholders, fees to lawyers and investment bankers have been paid, do raiders pay the rent? And what positive contribution do they make to the public weal?

This research suggests that raiders play a limited but significant role. With some notable exceptions (for example, Icahn's takeover of TWA) their deals are not contingent upon achieving operational efficiencies. Free-lance raiders, unlike their corporate counterparts who may seek intangible strategic advantages, are in the game for tangible dollars. To determine whether a profit can be made in a takeover by instituting operational efficiencies requires a detailed knowledge of the target's revenues and costs. And of course, in an unfriendly deal, the incumbent managers do not volunteer such

¹² Jensen (1986) has argued that high leverage "bonds" managers of companies to pay out their excess cash flows instead of wasting the firm's funds on organizational inefficiencies or value destroying investments.

information. Besides, many raiders are not steeped in operations and "running businesses better" is not their business.

What raiders are engaged in, say Goodson and Gogel, is "balance sheet arbitrage". They write: "In today's takeovers, the opportunity for arbitrage arises because there is an identifiable difference between the price of a company's securities and the value of its assets. The critical element is the investor's ability to identify that discrepancy."¹³

The discrepancy, this research will show, is apparently most easily identified, in the absence of insider operating information, in the case of diversified corporations. The raider assesses whether the price the individual businesses will command, on an as is where is basis, is higher than the cost of the company as a whole. If it is, the takeover can proceed at relatively low risk with "bridge financing" provided by lenders who are confident they will be quickly repaid. Sometimes, as in the case of Revlon and Frigitronics, the risk can be further reduced by pre-selling some of the businesses.

Adding value to individual businesses, by instituting operational improvements, making strategic changes, or adopting the right capital structure is then the responsibility, not of the raider, but of the ultimate buyer who has the skills and inclination. And in fact, it is probably the potential for adding value that attracts buyers and enables raiders to divest individual businesses quickly.

Refocusing American Industry

This seemingly limited, arbitrage or merchant banking function, of buying businesses wholesale and selling them retail, is, in fact, quite significant. It challenges a fundamental, long-term trend in the evolution of American industry -- the growth of the diversified, multi-business corporation through the combination of businesses that

¹³ Goodson and Gogel (1987)

operate in different industries. As observed by Chandler¹⁴ and documented by Rumelt¹⁵, the single (or dominant) business firm began to disappear from the ranks of the Fortune 500 after the second World War, giving way to the diversified corporation. The percentage of diversified companies in the Fortune 500 more than doubled from 1949 to 1974, rising from under 30%, to over 60%.

Most merger activity was geared to diversification rather than expansion within existing businesses -- over 70% of the assets acquired by industrial companies between 1961 to 1978, resulted from acquisitions that the FTC classifies as diversifying acquisitions.¹⁶

Therefore, the principal questions that needs to be addressed regarding hostile takeovers relate to their impact on corporate diversification rather than whether they lead to too much or too little debt or cuts in useful or wasteful investment. We need to know whether the multi-business corporate form is still a valuable one; and, if it has outlived its utility, whether hostile takeovers are the most appropriate remedy.

The stock market apparently doesn't believe diversification is useful, judging from the substantial discount to the value of their component businesses at which the shares of diversified corporations usually trade. But it should be recalled, in the Sixties, the stock market seemed to favor diversification and valued conglomerates at premiums to their component businesses. Was the market in error then or now? Or, has the utility of diversification declined?

I will argue that the market is probably more sophisticated in valuing companies today and that the value of diversification has declined over time. The multi-business corporation may once have been a more efficient allocator of resources than the external

¹⁴ Chandler (1962)

¹⁵ Rumelt (1974)

¹⁶ As per the broad definition: this category includes all acquisitions extending operations beyond present production or geographical markets. Salter and Weinhold (1979) p 14.

capital markets, and there may still be a few executives that can manage a portfolio of businesses exceptionally well. But, as a general rule, with the growing sophistication of capital markets, the diversified corporation has probably lost its edge. The focussed business that "sticks to its knitting" doesn't need to be supervised by another layer of management any more.

The raiders' attack on diversification rather than on inefficiencies in individual businesses may also explain the strong animosity of the Roundtable towards hostile takeovers. The executives who are under attack do not manage businesses -- they manage managers who manage businesses. Takeovers often create opportunities for the latter to get very rich -- for example, after Jacobs's takeover of AMF, his first priority was to sell the individual businesses to their managers; and, Hanson Trust¹⁷ is reputed to establish very attractive incentives for the operating managers of the businesses it acquires. On the other hand, hostile takeovers threaten the managers' managers' very function -- the question of how they do their jobs is secondary to the question of whether their jobs ought to exist at all. Do we really need executives to allocate resources between businesses if the capital markets can do the job better?

If the opportunity to raiders was provided merely by operating inefficiencies or unutilized debt capacity, incumbent executives could preempt raiders by working harder or smarter, surrendering some of their value-destroying perquisites, or swallowing their distaste for high leverage. But to the extent that the opportunity arises from the inappropriateness of the multi-business form, the managers' managers cannot fully preempt raiders without working themselves out of a job.

Hence the extreme antipathy to the raiders; and hence also the difficulty of reversing diversification without a change in control. Hostile takeovers may be clumsy

and messy and the reputations of some of the raiders may leave something to be desired, but we don't yet have a more effective method for effecting the creative destruction of obsolete organizations.

Another important issue raised by hostile takeovers relates to the value of "private" versus "public" ownership. When raiders break up diversified firms, a significant proportion of the units sold end up in the hands of private firms or partnerships. Is this transfer of control of businesses from public to private owners a coincidence or does it make a real difference? I will argue that private ownership is more suited to mature businesses that generate cash than public ownership; since many of the units spun off by the raiders are mature cash generators, the transfer in the form of ownership is probably a good thing.

Organization of the Thesis

The next chapter will be devoted to the "motives" of acquirers -- why it is useful to study the benefits acquirers expect from takeovers; what we already know; the methods I used to infer expected benefits; and, my findings.

Chapter 3 describes in detail the controversy regarding the consequences of hostile takeovers and the results of the tests I used to evaluate the claims of the pro- and anti-takeover camps.

Since the main impact of hostile takeovers appears to be to threaten corporate diversification strategies, in Chapter 4 I discuss the evolution of the multi-business corporation, and why the disadvantages of such corporations may now out-weigh the advantages. In Chapter 5, I explore the advantages and disadvantages of private and public ownership. Finally in Chapter 6, I discuss the implications of this research for public policy, managers, investors and for further research.

Chapter 2:
Expected Benefits:
What's in it for the raiders?

Understanding the nature and source of the benefits acquirers seek is an important step in sorting out the rival claims about hostile takeovers. For example, if we find that a large proportion of takeovers are launched because acquirers believe that the targets' stocks are undervalued, then Drucker's claims that the stock market's irrationality leads to hostile acquisitions would be buttressed. Likewise, if it can be demonstrated that acquirers believe they can make a bundle by changing the way target companies are managed, then we would have a stronger case for the theory that management inefficiencies, be they real or perceived, are behind hostile takeovers. Or, if it turns out that most acquirers stalk targets with the expectation of creating synergies, we would tend to reject both the stock market inefficiency and managerial incompetence hypotheses.

Knowing where they are headed will also enable us to speculate more intelligently about where the raiders will eventually end up. If, for example, hostile acquisitions are made in order to bet on "undervalued" stocks or to build empires, we would be more skeptical about their long term economic contribution. If instead we find that raiders usually pounce on what they perceive to be incompetent managers, we can then ask: Were the incumbent managers really "incompetent" by the yardsticks of long-term performance, or did they merely fail to deliver short term e.p.s. growth? And what is the nature and desirability of the changes that the raiders implement after the incumbents are purged?

Our enquiry into the benefits expected by acquirers will take us through the following steps. In order, I will describe the:

1. Existing theories and evidence about acquirers' motives. Here we will see that the current evidence does not help us discriminate between several possible theories.
2. Approach of this study -- my classification of expected benefits, the heuristics I used to infer expected benefits, and my sample.
3. Findings about the expected benefits in hostile takeovers. An overwhelming proportion of hostile takeovers, we will see, were undertaken by acquirers who expected to profit from "restructuring" their targets.
4. Contrast between expected benefits in hostile and friendly takeovers. Acquirers in friendly takeovers, we will see, were most frequently motivated by expectations of "synergy" or the advancement of some "portfolio" strategy and not by anticipated "restructuring" profits.
5. Contrast between pre- and post- junk bond era hostile takeovers. Expected benefits from hostile takeovers in the pre-junk bond era, we will see, had more in common with friendly takeovers in the post junk bond era than with hostile takeovers.

1. EXISTING THEORIES AND EVIDENCE

1.1 Existing theories

Given the newness of the phenomenon and the small number of available data points, it is not surprising that the nature and source of the benefits acquirers expect (their

"motives"¹) in hostile transactions has not been extensively studied. Turning to the literature on takeovers in general (which are predominantly friendly), is not particularly helpful either. As Roll's² excellent survey shows, several hypotheses about acquirers' motives have been proposed and numerous studies to test these hypotheses have been performed.³ Unfortunately, the voluminous empirical evidence does not help us eliminate or even determine the relative importance of the motives that have been suggested.

Two of the reasons listed by Roll can, however, be ruled out without much controversy.

The Monopoly Motive. The first wave of mergers, between 1890 and 1905, was, it is commonly agreed, motivated by the desire to create combinations or trusts that could extract monopoly profits. Times have changed since then: takeovers have to pass strict anti-trust scrutiny; and besides, (or perhaps because of anti-trust) the takeovers within an industry that could potentially lead to monopoly combinations are now a small fraction of all takeovers. Therefore, even critics rarely condemn takeovers on antitrust grounds.

The Information Hypothesis. According to this hypothesis, acquirers bid for a company because they have "private" information (about say, a gold deposit or a hot patent) which tells them that the true value of the target's stock is greater than its current market price. This hypothesis got a boost when several studies⁴ reported that even unsuccessful tender offers lead to a permanent increase in the target's stock price, suggesting that bids reveal new information to the stock market. Enthusiasm for the theory dissipated when Bradley, Desai, and Kim⁵ showed that the rise in the target's stock is not so permanent after all - if the unsuccessful bid is not followed by a successful offer

1 Although the word "motives" has broad connotations, I will consistently use the terms "acquirers' motives" in this thesis only as a convenient shorthand for "the nature and source of benefits expected by acquirers".

2 Roll (1985)

3 Jensen and Ruback cite nearly a 100 articles in their survey of the empirical literature.

4 For example, Dodd and Ruback (1977), Bradley (1980), and Firth (1980).

5 Bradley, Desai, and Kim. (1982).

in five years, stock gains are fully reversed.

In the opinion of this writer, the hypothesis is a bit of a straw man. It requires for example, the bidder to possess information that is unknown not merely to the public, but to the target's insiders as well; for, if insiders knew about the gold mine or patent, why would they keep it a secret from their shareholders and risk losing their jobs? And, the hypothesis does not explain why bidders would bother with paying the takeover premium that an acquisition inevitably entails. Why wouldn't they simply buy the stock on the open market, make their private information public, and then sell the stock at a healthy profit instead?

Refuting the information hypothesis, does not however address critics' claims that public investors misvalue stocks, not because they lack full information, but because they lack judgement.

The hypotheses that remain after the monopoly and information ones have been put aside can be conveniently classified, following Roll's scheme, into the following groups.

Synergy or combinational gains. Folding the target into the acquiring organization may be expected by the bidder to "create value". The many potential sources of this value, which range from realizing economies of scale (if the target is in the same industry as the bidder) to efficiencies in cash management (which may be realized even across totally unrelated businesses), have been extensively discussed in the Industrial Organization and strategy literature.⁶

Gains from replacing incompetent managers. Bidders may believe that value can be created by eliminating incumbent managers who are incompetent. This hypothesis reflects Manne's "market for managerial control" theory which says that takeovers reflect competition between rival teams of managers for the right to control a corporation's

⁶ See Scherer (1980) for a review of the Industrial Organization literature and Salter and Weinhold (1979) for the managerial literature.

assets.

Managerial self interest. Managers may attempt takeovers in order to maximize their own utility rather than the wealth of their stockholders. Acquisitions, it has been suggested⁷, can help managers avoid being taken over, reduce the unsystematic risk they are exposed to, provide psychic rewards or additional pecuniary compensation.

Takeovers may thus arise from an "agency" problem.

*Speculative gains.*⁸ The acquirer may attempt a takeover in the belief that the stock market is seriously misvaluing the target's stock. This argument while not academically respectable, is often advanced by "lay" critics of takeovers.

Financial/ Tax benefits. Acquisitions may be sought for their tax benefits. Takeovers can increase tax shields by allowing the targets assets to be written up and depreciated at a higher rate or because the acquisition is financed with debt.

In general, advocates of takeovers believe they are motivated by expectations of synergy or gains arising from replacing incompetent managers. Critics, on the other hand, would argue that takeovers are driven by expectations of speculative gains, managerial self interest, or tax benefits. And both sides can cite considerable evidence to support their point of view, leaving the argument at an impasse.

⁷ See for example, You, Caves, Henry and Smith's (1987) summary.

⁸ This hypothesis is not found in Roll's classification and one of Roll's hypothesis - the "hubris" hypothesis is not listed here. I made these modifications to reflect the difference between Roll's use of the word "motives" and mine. Although Roll claims to be discussing "hypotheses of takeover motivation", a close reading shows that his interest is really in hypotheses that explain why stock market value is created or destroyed. Consequently he includes "management hubris" as an independent hypothesis to explain why value might be destroyed but does not include speculation as a possible motive since (under assumptions of efficient markets) it can have no effect on market value. My interest is in the sources of value expected by the bidder rather than by the stock market. I therefore have no interest in determining whether acquirers are deluded in their expectations and do not include the hubris hypothesis. And conversely, I do consider making speculative profits as a feasible expectation on the part of acquirers.

1.2 Evidence behind the theories

Evidence for the synergy hypothesis

Jensen draws support for the synergy thesis from the positive returns to bidders that may be calculated by "averaging" the results of several event studies. From this evidence, he infers that ".... there is no systematic evidence that bidding company managers are harming shareholders to build empires. Instead, the evidence is consistent with the synergy theory of takeovers."⁹

Palepu's analysis lends support to the advocates' case. Palepu compares the characteristics of takeover targets between 1971 and 1979 with randomly selected companies that weren't targets. Using a multivariate binomial logit model, Palepu finds that: "management efficiency, growth resources balance, firm size and industry factors significantly influence the acquisition probability; and that the P/E ratio and the market to book value ratio have no significant impact on the acquisition probability. This evidence is consistent with the notion that takeovers are a mechanism through which bidders seek to replace inefficient managers and to realize synergies, and is inconsistent with the proposition that that the primary motive behind takeovers is the exploitation of perceived capital market misvaluations."¹⁰

If one believes that theory is ultimately reflected in practice, support for the synergy hypothesis can also be indirectly found in the "diversification" literature. There is a substantial body of prescriptive work that advises managers on how they should diversify, and by extension, the companies they should acquire. Suggestions that the acquiring company seek out targets with misvalued stocks or targets with incompetent managers are rare; and although the advice is addressed to managers rather than

⁹ Jensen (1984)

¹⁰ Palepu (1985)

shareholders, prescriptions on how members of the audience might advance their personal interests through acquisitions is discreetly avoided. Instead the emphasis is on combinational synergy -- how to develop an acquisition program that "fits" the acquirer's strengths and weaknesses: "The choice of a particular acquisition strategy", write Salter and Weinhold, "largely depends on identifying the route that best uses the company's existing asset base and special resources."¹¹

The specific source of the value created by combining target with acquirer is subject to fashion. When conglomerates were all the rage in the late 'sixties and early 'seventies, the diversified corporation was advised to maintain a balanced portfolio of mature and growth businesses; the corporation's value added lay in establishing an administrative and control system to extract cash from the mature businesses and invest it in the growth businesses.

The underlying theory was that resource allocation was more efficiently performed under a single corporate umbrella than by the capital markets because corporate planning departments could command better information; also, funds could be transferred from cash cows to stars, without the tax leakage that would occur if an independent cash cow paid out dividends to stock holders who then invested the after tax proceeds in an independent star. The value of the diversified corporation therefore could be greater than the sum of its parts. And acquisitions were critical to realizing this value, since a balanced portfolio could not be easily or quickly put together through internal development alone.

More popular today is the theory of related diversification. Acquisitions that lead to related diversification are recommended to companies that can "export (or import) surplus functional skills and resources relevant to [their] industrial or commercial

¹¹ Salter and Weinhold (1979)

settings..."¹² For example, a beer company that has a strong marketing capability which is not fully utilized might seek to purchase a soft drink producer whose profitability could be improved by the application of the beer company's skills.

There is evidence which indicates that the prescriptive theory has in fact been reflected in managerial practice. By 1979, reports Haspeslagh, "a new generation of strategic planning approaches called portfolio planning" had taken root in 45 percent of the Fortune 500 industrial companies. "Advocated by consulting firms like the Boston Consulting Group, McKinsey, and Arthur D. Little and touted by organizations like General Electric, Mead, and Olin, portfolio planning has struck the minds of many corporate executives."¹³

The pattern of acquisitions also suggest the pursuit of synergy. If acquisitions were made only in the pursuit of speculative profits or turnaround candidates, one would not expect to find the "fit" between acquirer and target that studies have shown seems to exist along several dimensions. Lemlin¹⁴, for example, has shown that diversification seems to occur within certain broad groups of industries (classified as producer goods, convenience goods, and non-convenience goods) rather than across groups. Further, he showed that within the producer group, companies seemed to seek acquisitions that would leverage their technology and, within the consumer group, acquisitions that leveraged their marketing skills.

Christiansen and Muzyka¹⁵ detect patterns that go beyond industry relatedness. They classified large diversified acquirers into eight groups, using a variety of "strategic, structural and financial" characteristics. They found that companies in different groups exhibited distinctive patterns of acquisition behavior -- for example, the "technically

¹² Salter and Weinhold, *op cit*.

¹³ Haspeslagh (1982)

¹⁴ Lemlin (1982)

¹⁵ Christiansen and Muzyka (1987)

oriented" group of firms tended to acquire other large, technically oriented firms, while firms in the "integrated production and distribution group" were likely to acquire small firms which could be vertically integrated into their existing operations. These findings suggest that acquirers have a purposeful acquisition strategy and seek a variety of synergies from folding in their targets. They are not in the business of making opportunistic raids on undervalued or mismanaged companies.

Evidence for the managerial self interest hypothesis.

The same sort of evidence that may be used to support synergy and elimination of the incompetent hypotheses can also be found to support the managerial self interest claim.

Reconsider for example, the evidence of event studies. Even advocates of synergy theories who insist that bidders' returns are positive concede that these returns are dwarfed by the gains to target shareholders. The question then arises as to why the acquirer's managers would embark on an undertaking that bestows a substantial windfall upon the target's shareholders but whose benefits for their own stock holders are small and uncertain. The most obvious answer must be that acquirers' managers are looking out for their self interest -- gains (or losses) to their stock holders are incidental.

You, Caves, et al explored the relationship between low bidder returns and managerial self interest. They found "substantial statistical evidence that ...losses [to bidders] are most likely to be inflicted when managers have the motive and opportunity to pursue their own utility at the expense of the wealth of their shareholders. These conditions are indicated by low proportions of the bidding firm's shares held by its managers and large proportions of inside directors on the board." Managers, they concluded, "are taking significant compensation in the form of mergers that fail to create

value for the bidders' shareholders".¹⁶

Other statistical evidence can also be mustered to support the self-interest claim. For example, Marshall, et al have found that the prevalence of diversifying mergers between industries is negatively related to the covariance of their cash flows¹⁷ -- this finding suggests that in assembling a diversified portfolio, managers seek to reduce the unsystematic risk facing their enterprises even though, according to financial theory, this does not benefit the diversified investor. Support for the hypothesis that acquisitions in unrelated industries ("conglomerate" acquisitions) are undertaken for managerial reasons is provided by Amihud and Lev's finding that such mergers are more likely to be undertaken where the firm's outside shareholders may be expected to exercise weak control over managers.¹⁸ And Firth¹⁹ found that mergers significantly increase directors' remuneration, thus providing them with a financial incentive to approve of mergers.

The descriptive management literature, which focuses on what managers actually do rather than what they should do, tends to support the self interest hypothesis. Most compelling is Donaldson's²⁰ finding that a principal objective of managers in large companies is the preservation of their independence from various constituencies, including their putative masters, the shareholders. This objective implies that firms seek financial self sufficiency and avoid raising funds from the capital markets. And, self sufficiency is admirably served by creating a diversified corporation where the losses and investment needs of some businesses are provided for by the profits and cash surpluses of the other businesses.

¹⁶ You, Caves, Henry and Smith (1987).

¹⁷ Marshall, Yawitz and Greenberg. (1984)

¹⁸ Amihud and Lev. (1981)

¹⁹ Firth (1980)

²⁰ Donaldson (1984)

If this view is accepted, the enthusiastic adoption of portfolio management is not surprising, since it provides managers with both the technology and the economic justification for pursuing self-sufficiency goals.

Evidence for the speculative gains hypothesis

Finally, let us turn to the speculative gains hypothesis. There is no systematic evidence for this academically disreputable thesis -- economists who know that markets are always efficient do not allow for the possibility that rational managers could indulge in speculation.²¹ Nevertheless, it is not fair to so summarily dismiss the hypothesis: First, we know that a majority of stock investors own the shares they do, because they believe their selection is undervalued relative to some other securities they could own.²² These investors don't claim to possess superior information about their stocks -- they just believe the market is wrong in its valuation. And there is no a-priori reason why managers initiating takeovers should not be making similar assumptions.

Second, there is at least anecdotal evidence that some acquirers make stock investments that can only be reasonably explained by the speculation hypothesis. For example, in 1981, Seagrams acquired a minority stake in DuPont which it committed not to raise to a controlling interest for a decade; also, Seagrams has no significant business dealings with DuPont. The most plausible explanation for why, as of this writing, Seagrams continues to hold its investment in DuPont is that Seagram's chairman, Bronfman, believes DuPont's shares are undervalued.

Third, at least a small number of managers do not hide the fact that their acquisitions are "investments" which they expect to appreciate because of some exogenous change. G.E.'s acquisition of Utah International and Fluor's acquisition of St.

²¹ But see Greenspan's Congressional testimony. (Congressional Hearings on Hostile Takeovers, 1987, p23)

²² Passive, indexed investors who believe that all stocks are fairly priced relative to each other still constitute a minority.

Joe's minerals were, according to the acquirers' managers, bets on commodity price inflation. And while other motives may have also played a role, there is no reason to rule out the rationale offered by G.E.'s and Fluor's executives.

To summarize this quick tour of the literature: several types of expected benefits or "motives" can reasonably be imputed to acquirers. Each motive can claim its share of empirical support²³, which suggests that all may play a role. But, from the evidence, we cannot determine the relative importance of the expected benefits or the proportion of takeovers involving each class of benefit. Our inquiry into what bestirs hostile acquirers must proceed without much help from the record of friendly takeovers.

2. APPROACH OF THIS STUDY

The literature on friendly takeovers did provide, when I surveyed it in the initial stages of this research, an important methodological lesson: researching the indirect statistical evidence - the "excess" returns, the financial characteristics and the industry "fit" between bidder and target - was not likely, even if such evidence were available (which it is not), to lead to more conclusive results for hostile acquisitions than it has for friendly acquisitions. Consequently, I decided to use a direct, quasi-clinical approach -- I would seek to infer the key benefit or benefits acquirers expected in a number of takeovers, by examining in detail each acquirer's long term track record as well as the specific circumstance of each attempted transaction.

2.1 Classification Scheme

I also made some modifications to Roll's classification scheme in order to arrive at a classification scheme that could be implemented without resort to subjective value

²³ Except the financial/tax hypothesis. As Roll reports "There are few empirical results ... even though direct evidence on tax benefits would seem easier to uncover than evidence about, say, synergy or inefficient management." Roll [1985], op cit.

judgements. As previously indicated, it is difficult to observe whether the expected benefit in diversifying acquisitions, especially of the unrelated variety, lies in the creation of cash management or other financial synergies, or greater independence for managers, or both. What can often be observed however is the existence of a corporate diversification strategy - a purposeful effort to increase the firm's presence in certain types of industries, invest its excess cash, or reduce the cyclicity of profits. Therefore:

1. I narrowed the synergy category to exclude those cases where acquirers expected to create value by combining or coordinating only the financial or resource allocation functions of the target with their existing businesses. My restricted synergy category required the expectation of synergies from combining or coordinating non-financial functions such as production or marketing. This restricted category corresponds closely to Salter and Weinhold's²⁴ use of the term "synergy", and to Porter's²⁵ description of corporate strategies based on exploiting interrelationships between businesses.

2. The "management self-interest" category was also narrowed to cover only those cases where the acquirers themselves were under imminent threat of being taken over and were seeking out an acquisition to neutralize this threat. Reflecting this restriction as well as a desire to avoid pejorative classifications, I re-labelled this narrower category of self-interest as "*defensive*".

3. I created a new "*portfolio*" category to cover cases where the expected benefit was the advancement of the acquirers' diversification strategy. This category is on the one hand a cop-out of sorts, since it subsumes cases where the expected benefit is really management self interest or the realization of financial or administrative synergies. On the other hand, the category does relate to managers motives in the real world - as Porter²⁶

24 Salter and Weinhold (1979)

25 Porter (1987)

26 Porter (1987)

puts it: "The concept of corporate strategy most in use is portfolio management, which is based primarily on diversification through acquisition."

My use of the category closely corresponds to Porter's description of a portfolio strategy wherein:

"The corporation acquires sound attractive companies with competent managers who agree to stay on... The acquired units are autonomous and the teams that run them are compensated according to unit results. The corporation supplies capital and works with each to infuse it with professional management techniques. At the same time, top management provides objective and dispassionate review of business unit results...

In a portfolio strategy, the corporation seeks to create shareholder value in a number of ways. It uses its expertise and analytical resources to spot attractive acquisition candidates that the individual shareholder could not. The company provides capital on favorable terms that reflect corporatewide fund-raising ability. It introduces professional management skills and discipline. Finally, it provides high quality review and coaching unencumbered by conventional wisdom or emotional attachments to the business."

4. In order to avoid pejorative labels, I replaced Roll's category of gains from "eliminating incompetent managers" to gains from "*restructuring*" the target. This category would cover situations where the acquirer expected to profit from ("create value" by) changing the target's strategy -- for example by

- o Changing the capital structure (usually by increasing leverage).
- o Divesting certain divisions, business units or product lines.
- o Implementing cost reduction programs.
- o Discontinuing investments that the acquirer believed had negative net present values (NPVs).

My use of the term restructuring closely parallels Porter's description of a firm following a restructuring strategy:

TABLE 1:
CLASSIFICATION OF BENEFITS EXPECTED IN TAKEOVERS

CATEGORY	NATURE OF EXPECTED BENEFIT
Create synergies (<i>Synergistic</i>)	Suitor expects that combining with target will create economic value because of scale economies, joint costs etc.
Build or redeploy corp. portfolio (<i>Portfolio</i>)	Acquisition fits suitor's "portfolio strategy" such as of investing in cash cows (or growth businesses) or some "attractive" sectors of the economy.
Acquire undervalued asset (<i>Investment</i>)	Suitor believes target is worth more than purchase price because of stock market misvaluation or some anticipated exogenous change in demand, prices, or costs.
Restructuring gains (<i>Restructuring</i>)	Value of target can be increased by some change in its operation or strategy such as divestitures, recapitalization or cost reductions.
Maintain Independence (<i>Defensive</i>)	Acquisition will make acquiror a more difficult takeover target.
Utilize tax credits/losses (<i>Financial</i>)	Acquisition will enable acquiror to take advantage of tax losses/credits

"Unlike its passive role as a portfolio manager, when it serves as banker and reviewer, a company that bases its strategy on restructuring becomes an active restructurer of business units. The new businesses are not necessarily related to existing units. All that is necessary is unrealized potential... The parent intervenes, frequently changing the unit management team, shifting strategy, or infusing the company with new technology."

One possible difference is that while Porter refers only to corporations following a restructuring strategy, I include individuals who might be interested in acquiring a company with a view to restructuring it.

5. Pragmatic reasons also dictated the narrowing of Roll's financial category. All takeovers have tax implications and acquirers naturally seek to maximize their tax benefits; but in most cases, it is difficult to determine how important these tax benefits were in the decision to proceed with a takeover. I therefore restricted the financial category to those cases where the search for an acquisition was motivated by the acquirer's desire to take advantage of existing tax credits or tax loss carry forwards - in other words, I excluded the benefits of writing up acquired assets or of the tax shield provided by the additional debt incurred in a takeover.

A summary of the modified classification of expected benefits is shown in Table 1.

2.2 Heuristics to infer expected benefits

The rationale articulated by the acquirer does not, by itself, provide a reliable guide to the benefits actually anticipated from a takeover - the stated reasons for making a bid can range from being complete and honest to utterly misleading. Expected benefits therefore must be inferred from a broader set of circumstantial evidence.

Fortunately, there is no dearth of qualitative and quantitative data on acquirers, targets and transactions. The real challenge I faced was to devise reasonable rules of inference that would take advantage of the available information while minimizing the

need to make subjective judgements about each case. Through a process of trial and error, I arrived at the following tests to provide "first pass" judgements about acquirers' expected benefits.

1. What was the acquirer's organizational form?

- o Synergistic or portfolio benefits would be ruled out if the acquirer was a private partnership organized for the transaction, a private investment shell etc.
- o If the acquirer was an on-going operating company, synergistic benefits would be indicated, especially if the company operated in a single industry.
- o If the acquirer was a diversified company, portfolio benefits would be indicated.

2. What was the acquirer's diversification strategy and track record in previous takeovers?

- o Synergistic benefits would be indicated if the acquirer exhibited a pattern of making acquisitions in the same (or related) industry and integrating acquired businesses into existing operations.
An example of an acquirer following such a strategy is Dun and Bradstreet. Its strategy is to acquire small data base companies and utilize its corporate marketing capabilities to broaden the distribution of the acquired data bases.
- o Portfolio benefits would be indicated if the acquirer exhibited a pattern of: making acquisitions in a variety of businesses and industries; treating acquired companies as stand-alone businesses and making few efforts to

coordinate non-financial functions across businesses; rarely divesting acquisitions unless they were perceived to be "failures".

Conglomerates like IIT, RCA and Allied Corp. fit this pattern.

- o Investment benefits would be indicated if the acquirer exhibited a pattern of: making opportunistic acquisitions in one or more industries; treating acquired companies as stand-alone businesses and making few efforts to coordinate non-financial functions across businesses; being willing to take non-controlling positions in companies; and, frequently selling its holdings, at a profit.

The most prominent example of an acquirer that fits the investment pattern is Berkshire Hathaway whose chairman, Warren Buffet is a legend in the world of "value investing."

- o Restructuring benefits would be indicated if the acquirer exhibited a pattern of implementing substantial changes in the strategy or operations of the acquired companies e.g. by increasing leverage, divesting assets or renegotiating wage contracts.

Examples of acquirers who have followed a restructuring acquisition strategy include Hanson Trust, Sir James Goldsmith and Asher Edelman.

3. Was the acquirer itself under attack before it initiated its takeover? Defensive benefits would be indicated if a raider had accumulated a substantial stake and unwelcome stake in the acquirer (or had actually made an overture).
4. Was the acquirer's takeover search motivated by the need to utilize substantial tax-credits or loss carry forwards? If it was, a financial benefit would be indicated.

The most critical of these tests obviously is the one relating to the bidder's prior acquisition "strategy". Recurring patterns of acquisition behavior provide more powerful and reliable insights into acquirer expectations than a "snapshot picture" of an individual transaction. And without this test it is difficult to narrow down the set of potential expected benefits, especially in the case of the average publicly held acquirer.

With some acquirers however, the power of this test was limited either because, like Flour before its takeover of St. Joe's, they did not have much of an acquisition history; or, the acquirers did not exhibit a consistent "pattern" in their acquisitions: Occidental Petroleum, for example, has implemented substantial changes in some of the companies it has acquired (suggesting a restructuring pattern) while other companies appear to have been acquired because the chairman wanted them in the corporate portfolio - Arm and Hammer, a baking soda producer, was bought it is said, because the chairman of Occidental, Armand Hammer, 'was tired of being asked whether he owned the company.'

Supplementary tests (summarized in Table 2) were therefore used to refine (or confirm) inferences arising from the primary tests. Very occasionally, the supplementary tests suggested "secondary" expected benefits that had not been uncovered by the primary tests.

2.3 Sample Selection

Core Sample

The core of my sample comprised all contested tender offers over \$100 million made in 1985 and 1986 -- a total of 47 takeover attempts.

I focused on contested tender offers because they are unambiguously hostile. An argument may reasonably be made that most unsolicited merger offers have a certain unwelcomeness attached to them. To the extent this is true, my interest in hostile

TABLE 2:

SUPPLEMENTARY TESTS USED TO INFER EXPECTED BENEFITS

Observation	Condition	Inferred expected benefit
Articulated reasons for merger	"Fit with technology/dist. channels etc."	Synergistic
	"Diversify out of steel/regulated ind." ; or "expand in services/high tech."; or "invest excess cash"	Portfolio
	"Good investment because of rising energy prices/inflation"	Investment
Announced post take-over changes	"Keep management intact/ Maintain as indep. sub."	Portfolio or Investment
	Divest assets, incr. leverage, cut costs	Restructuring
Business Overlap	Same industry acquisition	Synergistic
Analysts opinion	"Steep price paid"	Not investment or restructuring
	"Fit with acq.'s dist/tech etc."	Synergy
	"Stock undervalued"	Investment
Stock price	Stock selling below historic P/E, book, recent highs	Investment
Financial reserves	Low tgt. debt or high cash	Restructuring or Investment
	low acq. debt or high cash	Portfolio

takeovers was best reflected in contested tender offers which occupy the extreme end of the friendly-unfriendly spectrum, since they occur when negotiations between suitor and target have completely broken down. Also, as a practical matter, lists of contested tender offers in 1985 and 1986 have been published by W. T. Grimm, the acknowledged score keeper of the M&A business.

The years 1985 and 1986 were chosen because of the high level of hostile takeover activity (and controversy generated by the same!) as well as the relatively easy availability of the data.

Offers below \$100 million were excluded because of poor availability of data; in any event, these offers accounted for only about a quarter of the 62 contested tender offers reported by Grimm.

Since I was interested in investigating expected benefits, I included both successful as well as unsuccessful contested tender offers -- as Table 3 shows, a majority of attempts were in fact foiled, and my sample would have been considerably smaller if I had included the failed attempts.

Table 3

Contested Tender Offers in 1985 and 1986

	1985	1986	Total
Number of Contested Offers	32	40	62
Contested Offers > \$100m	24	23	47
of which:			
Successful Offers	12	8	20
Unsuccessful -- target rescued by White Knight	8	11	19
Unsuccessful -- target remained independent	4	4	8

Control Groups

I also picked two control groups. The first consisted of a set of 23 randomly selected friendly (or at any rate not contested) takeovers in 1985. The purpose of selecting this group was to test whether the distribution of expected benefits in friendly transactions is the same as in hostile transactions. If the expected benefits were found to be similar, then we would have a leg up in our investigation of the consequences of hostile takeovers, because we could then more reasonably extrapolate from the findings about the consequences of friendly takeovers. If not, we would have reason to start de novo.

Conventional economic wisdom would advise against bothering with such a test. According to the economists' paradigm, resistance to a bid may develop because target managers, acting in their shareholders' interest seek to elicit a higher bid; or, acting in their own interest, determine that their payoffs -- their golden parachutes, stock options, and the like -- provide inadequate recompense for their loss of pay and privileges.²⁷ Acquirers' motives, in any event don't make any difference in the target's decision to resist.

This view, which implicitly assumes that only pecuniary inducements can persuade managers to voluntarily leave office, it can be argued, is excessively narrow. Casual observation suggests that senior managers can develop personal attachments to the well-being of their institutions and subordinates, which transcends their pecuniary interest.

Vancil's work on CEO succession²⁸, for example, shows that members of a board and the departing CEO will often favor a new leader who is likely to preserve the values

²⁷ See Walking and Long (1984)

²⁸ Vancil (1987)

and culture of the organization, and sometimes, even the existing strategy. Logic suggests that the board (and incumbent CEO) of a target company are likely to apply similar standards in evaluating a takeover bid. All other things being equal, they are more likely to oppose bids from acquirers expected to change the nature of the organization or purge the second level of managers who remain after the board and senior executives have left.

Gaddis's²⁹ account of the events at E.R.G., an oil and gas company that came under attack, supports this inference. "As directors", Gaddis recounts, "we felt a moral obligation to serve the best interests of .. the highly capable managers and supervisors who had remained loyal to the company..." When E.R.G. faced takeover threats, the directors' loyalty to managers appeared to play an important role in their response: "As we analyzed the management, resources, and intentions of our potential acquirers, we came to classify them as either "Type A", those who recognized the value of an effectively functioning management organization, or "Type B", those who did not recognize management effectiveness or care about preserving it."

Type B acquirers were strongly resisted -- in one case, the board decided to pay greenmail to a raider. And eventually, E.R.G. sought out and concluded a friendly deal with an acquirer who promised to preserve its management team.

Therefore, notwithstanding conventional wisdom, I decided it was worth investigating the hypothesis that the restructuring motive is more likely to be observed in hostile takeovers than in friendly takeovers.

An argument can also be made in favor of the hypothesis that expectations of synergistic and portfolio benefits are less likely to be observed in hostile takeovers. The realization of both these benefits requires some level of integration of the target into the

²⁹ Gaddis (1987)

acquirer's organization, which may in turn, require the cooperation of the target's managers. If in such cases, the incumbent managers signal that they strongly opposed being taken over, their opposition alone may deter acquirers from launching a hostile bid.

A second control group consisted of hostile transactions attempted in 1981. The purpose behind selecting this group was to test the hypothesis that the benefits expected by acquirers in hostile transactions in the 1981, "pre-junk bond" era were different from those of the more recent raiders. Specifically, I expected to find that the incidence of "restructuring" motives would be lower in the 1981 takeovers, while synergy and portfolio motives would be higher.

Finding the list of companies for the second control group proved problematic. Contested tender offers in 1981 were fewer and were aimed at smaller companies; worse still, since hostile takeovers were not a big deal then, Grimm did not publish a list of transactions! Eventually, after conducting a literature search of articles on hostile takeovers published in the business press, examining the Securities Data Corporation's list of all tender offers to determine which were contested, and lowering my cutoff to \$75 million, I was able to arrive at a list of 13 attempted hostile takeovers in 1981.

I relied on public sources to collect the data needed. These included:

- o Annual reports, 10Ks and proxy statements.
- o Literature searches of the PROMPT data base.
- o Value Line and other analysts reports.
- o Moody's bond rating reports.
- o Moody's Industrial and Financial Annuals.
- o Dun and Bradstreet, and Standard and Poor's directories of corporate managers.

- o The Wall Street Journal annual indices, and selected full text stories.
- o The DATEXT data base.

3. FINDINGS ABOUT EXPECTED BENEFITS

Inferences about benefits expected by hostile acquirers in 1985 are summarized in Table 4. (An appendix to this chapter summarizes the key data used to make these inferences). As the table shows, more than one primary benefit was inferred where the application of my rules so indicated, even though in my personal judgement, one of the expected benefits was more important than the others.

Also listed in Table 4 are "secondary" benefits, which were supported by very weak evidence.³⁰ These are included only for the sake of completeness and can, for most practical purposes, safely be ignored.

As can be seen from Table 5, "restructuring" profit appeared to be the primary expected benefit in two thirds of hostile attempts, while evidence of "portfolio", "synergistic" and "investment" expected benefits was found in only a small fraction of attempts.

Table 5

Distribution of Expected Benefits in Hostile Takeovers	
Nature and Source of Expected Benefit	Percentage of Targets (n=47)
Restructuring	68%
Portfolio	17%
Synergy	28%
Investment	4%
Financial (Tax)	4%

³⁰ For example when Inland Steel bid for J. M. Tull (a steel distributor), Inland's managers did claim that the merger represented a "related" diversification. There is however no other evidence that Inland seriously intended to derive any

TABLE 4

**BENEFITS EXPECTED IN CONTESTED TENDER OFFERS
1985 TARGETS**

Target	Suitor		Primary Expected Benefit		Secondary Expected Benefit
Crown Zellerbach	James Goldsmith	R/I	Divestitures/ Bet on timber		
Am. Natl. Resources	Coastal Corp.	R	Leverage	I	Depressed industry, cheap stock.
AMF Inc.	Minstar	R	Divestitures		
SCM Corp.	Hanson Trust	R	Divestitures		
Revlon	Pantry Pride	R	Divestitures. + Lev	F	Tax considerations
Pacific Lumber	Maxxam Grp. Inc.	R	Lev. + divestiture + acc. harvest.	F	Need op. co for tax reasons
Easco Corp.	Equity Group	R	Divestitures		
Gt. Lakes Intl.	Itel Corp	R/I	Leverage / bet on bus. upturn	F	Tax considerations
Southland Royalty	Burlington Northern	P	Add energy cos.	I	Bet on energy
McGraw Edison	Cooper Industries	P/R	Add elect. bus / cut costs		
Informatics Genl.	Sterling Software	S/R	Consol. mktg., adm & pdt. lines/		
Uniroyal Inc	Carl Icahn	R	Divestitures		
Cluett Peabody	Paul Bilzerian	R	Divest. + lev.		
Midcon Corp	Freeport/W&B	R	Divest + Lev.		
J.M. Tull Ind	Inland Steel	P	Diversify out of steel	S	Fit with metals bus.
Frontier Holdings	Texas Air	R/S	Integrate routes/ cut costs		
Richardson Vicks	Unilever	S/P	Leverage channels/ Expand U.S. presence		
Hook Drugs	Rite Aid	S	Skills\ Scale econ.		
Unidynamics	Nortek	P	Growth thru' acq.	R	Divestitures
Times Fiber	LBO	R	Divest. + cut costs		
Unocal	Mesa Pete.	R	Lev. + Harvest resv. + div.		
Phillips Pete.	Carl Icahn	R	Lev. + Div.		
Union Carbide	GAF Corp.	R	Lev. + Div.	R	Rationalize some chem. bus.
CBS Inc	Turner Broad.	P/S	Build ent. empire/ common skills		

TABLE 4 (Cont.)

BENEFITS EXPECTED IN CONTESTED TENDER OFFERS
1986 TARGETS

Target	Suitor		Primary Expected Benefit	Secondary Expected Benefit
White Consolidated	A.B. Electrolux	R/S	Cut Costs/Broaden prod. line	
Saga Corp.	Marriot Corp.	S	Scale econ + supplier power	
Ryan Homes	N.V. Homes	S	Broaden prod. line	
Ponderosa	A. Edelman	R	Lev. + Div.	
C.H. Masland	Burlington Ind.	P/S	Enter automotive carpeting	
N.L. Industries	Harold Simmons	R	Spin off chem. unit	
Frigitronics	Revlon Group	R	Divestitures	
Allied Stores	Campeau Corp.	R/S	Lev.+Div/ Real estate synergies	
Safeway	Dart Group	R	Ops. improvements + Lev. + Div	
Chesebrough Ponds	American Brands	P	Diversify out of cigarettes	
National Gypsum	Wickes Cos.	F	Use tax credits	R Lev.
Sanders Assoc.	Loral Corp.	S/P	Techn. fit + expand def. elec.	
Hammermill Paper	P. Bilzerian	R	Div. + Lev.	
Fruehauf Corp.	A. Edelman	R	Div. + Lev. + cost cuts	
Anderson Clayton	Bear Stearns	R	Div. + reduce excess cash.	
Joy Mfg.	Pullman Peabody	P/R	Reduce earnings cyclicalilty	
John Blair	MacFadden Hldgs	R	Divestitures	
Mayflower Grp.	Laidlaw/Transp.	S/R	Div. + Shared skills	
Avondale Mills	Dominion Text.	S	Op'nal Synergies	
Gillette Co.	Revlon	R/S	Div. + Lev. + shared channels	
Owens Corn. F'glass	Wickes Cos	F/S	Tax credits + fit with roofn'g bus.	
Carter Hawley Hale	E.J. DeBartolo	R/S	Divest. + real est. syn.	
Strawbridge & Cloth.	Berry Acq.	R	Div. + Lev.	

This distribution of motives is not consistent with claims that misvaluation by the stock market leads to hostile takeovers. As previously mentioned, critics like Drucker and Law³¹, have implied that a short sighted, volatile stock market creates opportunities for raiders. The link between short sightedness and opportunities for raiders is not always clearly drawn, but a simple mechanism may be posited: short term traders generate sharp swings in the market -- sometimes prices are too high relative to a firm's true value and sometimes they are too low. Sharp eyed raiders who have a better feel for values can step in and acquire a company on the cheap when the herd has irrationally bid down its stock.

Although such views are at odds with the prevailing financial economists' paradigm, I do not believe that the possibility of occasional lapses in stock market rationality can be ruled out. Evidence that airworthy 'planes can fly is not proof that they never crash. Likewise, evidence about the random nature of stock prices movements and the stock market's ability to see through certain accounting changes does rule out the possibility that, on occasion, the stock market may be too volatile, and even heavily traded securities may be undervalued.

Shiller's research for example raises serious questions about whether the volatility of aggregate stock prices is justified by changes in economic fundamentals.³² His tests have been criticized on the grounds that they assume that the future levels of dividends follow a stationary stochastic process, but this seems a bit of quibble considering the magnitude of the discrepancy uncovered. According to the Shiller tests, volatility in stock prices was about five times what it should have been.

Then there is the open and shut case of closed-ended funds. Closed ended funds are

synergies from the combination. Therefore "synergy" is listed only as a secondary expected benefit, in Inland's bid for Tull.

31 Law (1986)

32 Shiller (1981)

corporations whose only "business" is to invest in other securities. Unlike open ended mutual funds which continuously accept or return funds to investors, closed ended funds raise funds only once, through a public issue of stock. Thereafter, if the initial investors want to cash in, they must find other buyers for their stock -- managers of closed ended funds do not have to redeem the shares they have issued.

Stocks of closed ended funds usually trade at a discount to the value of the securities they hold. The discount as Mullins³³ has pointed out is consistent with the notion of an efficient market and rational investors. Stockholders have limited ability to force the managers of closed ended funds to maximize firm value. Managers may, for example, pursue their own ends by running up unnecessary expenses, taking excessive risks, or even entering businesses outside the original charter of the fund.³⁴ Consequently, investors have good reason to believe that closed ended funds are worth less than the value of their assets and, on the face of it then, the discount in their price is indicative of the efficiency of market prices.

The other facts about closed ended funds however are greatly at odds with efficient market theory. First, there is the very fact that they get started. Why do supposedly rational investors buy stocks of closed ended funds when they are issued (usually at a 5-7% *premium*, to compensate the brokers) when logic and experience inform that they will trade at a discount later? (And the amounts raised, we might add, are not trivial -- in 1987 and 1988, several billion dollar new issues were successfully brought to market.)

Second, stocks of closed ended funds creep to a discount for weeks after they are issued. Even if we dismiss the initial buyers as exceptional patsies, we should expect an efficient market to bring the stocks down to their proper discount the moment they begin trading freely.

³³ Mullins (1984)

³⁴ Hopper Soliday, for example, bought a brokerage firm at what some observers believe, was an excessively rich price.

Third, discounts of "seasoned" funds are unstable -- it is not uncommon for a stock fund to go from a 20% discount to a 10% discount and back in a matter of months. Surely such variation is better explained by emotion than by sudden changes in managers propensities to take advantage of the fund's shareholders. If a stock is fairly discounted at 10%, can we really dismiss the claim that it is cheap at a 20% discount?

There are other demonstrable cases of underpricing. For example, it can easily be shown that in an efficient market, stock index futures should sell at a premium³⁵ to the value of the underlying basket of stocks. Yet for nearly all of 1987 and much of 1986, Value Line futures consistently sold at a discount to the underlying securities. If this actively traded future could trade below its arbitrage value, how can we reject the possibility that lesser known stocks may occasionally be undervalued?

What is possible with the universe of stocks, however is not necessarily what is probable with respect to the particular takeover targets studied. Stock market irrationality, real or perceived, seems unlikely to have played a major role in inducing hostile takeovers in 1985 and 1986. In only 3 of the hostile takeover attempts studied is there any evidence that acquirers expected to benefit from undervaluation of the target. And in two of these three cases, the acquirer's bet appeared to be more on the misvaluation of some underlying resource market than on the stock market: Sir Goldsmith seemed to believe that the market for timberland was depressed, when he bid for Crown Zellerbach; likewise, the chief executive of Burlington Northern (who had once been the CFO of a large oil company) was betting on rising oil prices "through" the acquisition of Southland

³⁵ Roughly equal to the difference between the T-bill rate and the expected dividend yield on the stocks in the index.

Royalty.³⁶

Other evidence, drawn from Value Line's stock reports on the targets, also suggests it is unlikely that market misvaluation was an important factor in the 1985 takeovers.

- o Acquirers did not bid bargain prices relative to the book values or historic price earnings (p/e) ratios of their targets. On average, acquisition p/e ratios were 2.9 times the median 10 year p/e ratios of the target, and there were no cases of acquisition p/e s being less than the long run p/e. Similarly the average acquisition price offered was 1.9 times the target's book and only one bid was made at less than book. (See Table 6)
- o Occasionally (as in Maxwell's attempted takeover of Harcourt Brace Jovanovich) it is claimed that raiders seek to snap up companies after their prices have fallen steeply. This does not appear to be the case with most of the takeover attempts in our sample -- on average, as Table 6 shows, acquisition prices were 40% greater than the highest price reached in the prior year.
- o Value Line, one of the rare stock picking services that appears to consistently outperform the market, deemed only one target stock to be an attractive purchase shortly before takeover bids were made. (See Table 7)

³⁶ In the other "restructuring" motivated takeover attempts of oil companies (e.g. Pickens's tender offer for Unocal) the implicit bet about oil prices merely was that they would not fall to a level that would jeopardize interest payments on the debt raised to finance the acquisition.

Table 6

Premia offered in Hostile Takeover Attempts

	Acquisition Price as a multiple of:		
	Median p/e (n=36)	Book Value (n=42)	Prior Year High (n=42)
Average	2.9	2.2	1.4
(t-stat*)	(9.4)	(14.3)	(21.8)
Median	2.1	1.8	1.4
Minimum	1.0	0.9	0.9
# of Attempts in which multiple < 1	0	1	1

(* t-stat is for null hypothesis of multiple less than one)

Table 7

Attractiveness of Targets before Takeover Attempts

Value Line's Assessment of Target Attractiveness	Percentage of Targets (n=42)
Above Average	7%
Average	65%
Below Average	28%

The second important inference we may draw from the findings about expected benefits is that *they are strongly consistent with Manne's "market for managerial control" theory of takeovers*. In about two thirds of cases, acquirers apparently believed they could profit from a takeover by "doing something different" with the target, and were willing to put their theory to the financial test. In fact, in over half the cases, restructuring was the only expected benefit -- in these cases acquirers appeared to be looking exclusively at what could be done with the target, without any reference to how it

TABLE 3

BENEFITS EXPECTED IN FRIENDLY MERGER ANNOUNCEMENTS IN 1985

Target	Suitor	Primary Expected Benefit		Secondary Expected Benefit
R.C.A.	General Electric	P	Acq. cash generator	S Mktg & tech. econ.
Amer. Broad. Co.	Capital Cities	S/R	Shared skills/cut costs	.
Jack Eckerd Corp.	Mgmt. + Merrill	D	Escape Dart takeover	R Cut costs + lev.
Gulf Broadcast Co.	Taft Broadcast. Co.	P	Emphasize b'cast. + geog. expn.	I Bet on sunbelt
Gulfstream Aerospace	Chrysler Corp.	P	Diversify out of autos	S Tech. transfer
SCOA Ind. Inc.	T.H. Lee + Drexel	R	Divest. + lev.	I Cheap stock
Hoover Universal	Johnson Controls	D	Escape Posner takeover	S Common techn.
Lorimar Inc.	Telepictures Corp.	S	Access to network mkts	
Conwood Corp.	Dalfort Corp.	F/R	Tax benefits/ Lev. + div.	
Commun. Ind.	Pacific Telesis	P	Acq. Unregulated bus	
Union Trust Bancorp	Bank of Virginia Co.	S	Shared skills	
Alamito Co.	Mgmt. LBO	R	Lev.	
Scott Fetzer Co.	Berkshire Hathway	I	Undervalued stock	
Chilton Corp.	Borg Warner Corp.	P	Add to svs. holdings	
Farm & Home Svgs.	Pacific Realty	P	Div. out of real estate	S Backward integ.
G.C. Murphy co.	Ames Dept. Stores	S/R	Shared skills/ cost cuts	I Buy cheap co.
1st Bnks. Corp of Fla.	1st Union Corp	S/P	Shared skills/ Geog. expn.	
Shop & Go Inc.	Circle K Corp.	S	Mktg. & dist econ.	R Lev.
International Bank	USLICO	P	Growth thru' acq.	R Divestitures
Dyco Petro Corp.	Diversified Ener.	P	Acq. unreg. sub, invest excess FCF	
Franklin Bancorp.	United Jersey Banks	S	Shared skills	D NJ banks attractive targets
Mite Corp.	Emhart Corp.	P	Inv. excess cash	
Cluett Peabody	West Pt. Pepperel	P	Diversify out of textiles	S Fit with text. mfg.
Hook Drugs	Kroger Co.	P	Add drugstores	S Acquire skills
J.M. Tull	Bethlehem Steel	P	Vert. diversification	F Profitable co. to offset losses.
Unidynamics	Crane Co.	P	New mkt entry	
Midcon	Occidental Pete.	P/S	Add energy/ vert. intg.	I Buy undervalued cos.
Uniroyal	Mgmt. LBO	R	Divestiture	
Frontier Hldg.	People Exp.	S	Acq. routes/gates	
Richardson Vicks	P & G	S	Broaden prod. line.	P Expand OTC drugs business.

fit with their existing businesses.

If all the attempts involving a "restructuring" motive had succeeded, the main outcome would probably have been the redrawing of corporate boundaries: in all but five of the 32 restructuring attempts, the "doing something different with the target" apparently included selling of subsidiaries; changing financial structure was probably anticipated in about 15 attempts, while cutting costs seemed to be a major factor in only 6 attempts.

4. CONTRAST WITH FRIENDLY TAKEOVERS

Inferences about benefits expected for each friendly takeover studied³⁷ are listed in Table 8. As the Chi-squared test for independence of the distributions in Table 9 shows, the distribution of expected benefits in friendly takeovers is markedly different from the distribution of benefits in hostile takeovers: The null hypothesis that the the distribution of expected benefits is independent of whether or not a takeover is hostile or friendly is rejected at a .5% level of significance.

³⁷ The list of 30 transactions includes 8 acquirers who acted as friendly white knights to rescue the targets from hostile acquirers. There appear to be however few differences between benefits expected by white knights and acquirers in other friendly acquisitions, and none of the inferences noted below would be materially different if white knights were included in the sample.

TABLE 9

**DISTRIBUTION OF EXPECTED BENEFITS:
HOSTILE VERSUS FRIENDLY TAKEOVERS**

Primary Expected benefit(s)	Attempts in which observed	
	Hostile Attempts (N=45)	Friendly transactions (N=29)
Restructuring	25	3
Portfolio	6	13
Synergistic	4	6
Investment	0	1
Defensive	0	2
Portfolio + Synergistic	4	2
Restructuring + Synergistic	6	2

The chi-squared statistic for independence was 23.6 with 6 degrees of freedom.³⁸

One major difference between the friendly and hostile distributions is the relatively low level of "restructuring" cases. Where two thirds of the acquirers in hostile attempts expected restructuring profits to be a major benefit of their takeovers, only 17% (or 5 acquirers), harbored such expectations in friendly transactions. This finding is consistent with the hypothesis that the directors and senior executives of a target are more apt to resist acquirers who are expected to make wholesale changes in their companies.

The "direct" evidence, drawn from observations of acquirer behavior thus reinforces the inference drawn by Morck et al.³⁹ who found that "targets of hostile and friendly bids

³⁸ Two modifications were made to the data displayed in Table 4 in order to create the mutually exclusive expected benefit categories necessary for this test: 1) In 3 observations, I determined one expected benefit really dominated. 2) I dropped one observation which seemed to be an isolated pathology – the friendly acquisition of Conwood which involved a combination of restructuring and financial benefit. These modifications do reduce the power of the test to a certain extent.

³⁹ Morck, Vishny and Schleifer (1988)

have asset and ownership characteristics that one would expect of the targets of disciplinary and synergistic mergers, respectively."⁴⁰

It is also instructive to look at the few cases where "restructuring" benefits were involved, and speculate as to why the transaction was nevertheless friendly. In three out of the five cases, special factors seem to have been involved.

- o In the case of the Uniroyal and Alamito acquisitions, incumbent managers were key players in the acquiring group; it was also apparent that if the management led group didn't acquire and restructure the target in an ostensibly friendly transaction, raiders would do the job after a hostile takeover.
- o Analysts⁴¹ suggest that ABC voluntarily merged with Capital Cities, in spite of the latter's reputation as a tough cost cutter because ABC's chairman, who was on the verge of retirement, and its board believed that: 1) There was no natural successor to the chairman within the company; 2) Capital Cities executives were exceptional managers and would be good for the institution in the long term and 3) ABC needed protection against "undesirable" raiders like Saul Steinberg and Turner Broadcasting who had reputedly been accumulating ABC's stock.⁴²

Balancing out the low proportion of "restructuring" benefits in friendly takeovers is a high proportion of "portfolio" and "synergistic" benefits. Advancement of some "portfolio" objective was a major benefit expected by acquirers in nearly half of friendly announcements and "realization of synergies" in just under a quarter of friendly announcements.

A benign reading of these proportions is that the hand of "strategy" and "portfolio

⁴⁰ Their definition of disciplinary mergers, incidentally, is very close to my restructuring category, while their definition of synergistic mergers covers all non-restructuring categories.

⁴¹ See for example, Value Line's report of April 5, 1985.

⁴² The takeover also made ABC's chairman, Harvey Goldstein \$20 million richer.

management" theories is writ large over friendly takeovers and is largely missing in hostile takeovers. A less charitable interpretation may also be drawn. Recall that the "portfolio" category was defined because it is hard to observe the difference between the advancement of management self interest and the pursuit of financial synergies; if one ungenerously believes that "portfolio" motivated takeovers are really motivated by managerial self interest, one may infer that friendly takeovers are more likely to be motivated by executives' desires to build empires, preserve their independence vis-a-vis shareholder etc. than hostile takeovers. And thus if results track intentions, the skeptic may expect more adverse consequences to follow from friendly takeovers than from the much maligned hostile deals.

The different expectations of takeovers, it might be observed in passing, might arise from the dissimilar backgrounds of the key players. Most of the key players in the organizations that attempted friendly takeovers, were what Whyte might describe as Organization Men.⁴³ They had spent their careers rising through the ranks of large organizations and been extensively exposed to beliefs about the value of synergy and diversification, and the continuity of institutions. Lacking significant personal equity stakes in the enterprises they managed, these executives may have been more prone to regard stockholders as a potentially hostile pressure group. Such men were also more likely to inspire the confidence in the targets' decision makers that they were "Type A" acquirers, and thus less likely to evoke resistance to their merger overtures.

In contrast, as Table 10 shows, many of the key individuals involved in making hostile raids were what might be called entrepreneurs. They had not risen through the ranks of large companies -- they were (like Boone Pickens of Mesa) founders of their own companies, or financial dealmakers (like Icahn) or sometimes, (as in the case of

⁴³ Appendix 2 contains thumbnail biographies of the key players in the acquirers studied.

Lorenzo of Texas Air) financiers turned founders of companies. Being "outsiders", they might be expected to be more questioning of the status quo and willing to make radical changes after their acquisitions. Owning significant stakes in their enterprises (see Table 11), they were less likely to make acquisitions that were not in the best interests of their principals. And, one would expect that target board members and executives to have a stronger animosity towards a takeover attempt by such individuals than they would to one made by "one of their own".

Table 10
Backgrounds of Acquirers' Decision Makers

Backgrounds	Percentage of Attempts	
	Hostile Acquirers (N=46)	Friendly Acquirers (N=28)
Professional Manager	30.4%	71.4%
Entrepreneur	67.4%	21.4%
Other (Family)	2.2%	7.1%

Table 11

Insider Ownership of Acquiring Entities

Level of Insider Ownership	Percentage of Attempts	
	Hostile Acquirers (N=44)	Friendly Acquirers (N=26)
Low (under 5%)	13.6%	57.7%
Medium (Between 5 to 20%)	20.5%	23.1%
High (Above 20%)	65.9	19.2%

Finally, we may observe one similarity between friendly and hostile attempts -- perceived stock market misvaluation played an unimportant role in both types. Only in the case of Berkshire Hathaway's acquisition of Scott Fetzer do we have evidence of an acquirer seeking to purchase a cheap stock.

5. CONTRAST WITH 1981 TAKEOVERS

The distribution of expected benefits for the 1981 takeovers studied is shown in Table 12. The table includes expected benefits in 13 hostile attempts (of which 5 were successful), as well as in 8 white knight rescues.

Given the small number of observations we cannot make "statistically significant" conclusions, and whatever inferences I do make should be regarded as tentative.

TABLE 12

**DISTRIBUTION OF EXPECTED BENEFITS:
1981 TAKEOVERS**

Primary Expected benefit(s)	Attempts in which observed (Percent)	
	Hostile Acquirers (N=12)	White Knights (N=8)
Restructuring	8.3%	0
Portfolio	42.0%	75%
Synergistic	42.0%	25%
Investment	50.0%	12.5%

Notes: Percentages do not add up to 100, since more than one benefit was inferred in several cases

The most important inference that can be (tentatively) drawn from Table 12 is that *hostile takeover attempts in 1981 had more in common with the friendly takeovers of 1985 than with the hostile takeovers of 1985 and 1986*. As with the friendly takeover of 1985, evidence of expected "restructuring" benefits is scarce; and a high proportion of takeover attempts seem to have been motivated by expectations of synergy and the advancement of portfolio objectives. This suggests that the economists' claim that "acquirers' motives have nothing to do with the friendliness of a takeover" may well have had some basis in 1981.

This is not surprising. Prior to the advent of junk bonds in 1983, only established corporations and their managers could play in the takeover game, since acquisitions could be financed only through the issue of the acquirer's debt or equity. Free-lance individuals could not, as they do now, finance deals by borrowing against the assets of the target they were seeking to acquire. The acquirers who were most likely to make substantive changes were therefore shut out of the takeover business. The acquirers who could finance bids were a relatively homogenous lot with similar beliefs about what constituted a legitimate purpose for a takeover: as Table 13 shows, most were career managers. Resistance by the target (which would necessitate a hostile takeover) was therefore less likely to vary with expected benefit and would primarily depend on the price offered and the incentives facing the incumbent managers.

Table 13
Backgrounds of Acquirers' Decision Makers
1981 Takeover Attempts

Backgrounds	Percentage of Acquirers	
	Hostile Acquirers (N=12)	White Knights (N=8)
Professional Manager	75.0%	87.5%
Entrepreneur (Founder, Dealmaker)	17.0%	0%
Other (Family)	8.0%	12.5%

One additional inference that might be drawn from the 1981 data is that *perceived market misvaluation may have been an important factor in motivating takeovers* -- in 50% of attempts, acquirers seemed to expect gains from buying an undervalued stock. This may be explained by two factors. One was the stock market as a whole was much "cheaper" in 1981 than it was in 1985 by almost any measure -- on an absolute price basis, or in terms of the ratio of stock prices to earnings, book value, or replacement value of assets. Second, the U.S. was going through a period of high inflation, and several of the "investment" attempts (e.g. Seagram's bids for Conoco and St. Joe's Minerals) were really a bet on continued commodity price inflation.

6. SUMMARY AND CONCLUSIONS

Our study of the benefits expected by acquirers in this chapter led to two important inferences. First, whatever the other consequences of the alleged fickleness of the stock market may be, it is unlikely that (at least in recent years) the misvaluation of target stocks has induced hostile bids. Raiders appear to be seeking opportunities to make "restructuring" profits rather than passive investments in undervalued stocks.

Second, benefits expected by acquirers in friendly transactions are usually different from those expected by acquirers in hostile transactions. Friendly mergers are much

more likely to be motivated by managerial theories or self-interest than by expectations of profits from performing radical surgeries on ailing targets.

The difference between hostile and friendly takeovers has significant implications for our inquiry into the consequences of hostile takeovers, which we will pursue in the next chapter: first, the differences in expected benefits suggest that our experience with friendly takeovers should not be used to predict the long term effects of hostile transactions. And second, as far as the short term effects are concerned, we may predict that more sweeping changes are likely to result from hostile takeovers, especially those involving "restructuring" expectations.

Chapter 3: Short Term Consequences

The long-term record of takeovers in general, which, we will see below, is quite dismal, is not a reliable predictor of how the current crop of hostile takeovers will eventually turn out. Pending the unfolding of history, the next best thing we can do is to evaluate the short-term consequences of the raiders' handiwork. There are however, few hard facts to guide us in this appraisal -- the lively controversy about whether or not raiders dangerously leverage up companies or slash long-term investment is largely based on anecdote and speculation. The research I will describe in this chapter represents an attempt to bring some evidence to bear against the more important claims about the short-term effects of hostile takeovers. The evidence, we will see, is not consistent with most of the criticisms of hostile takeovers, but nor does it support the more enthusiastic claims that have been made on the raiders' behalf.

To preview the material in this chapter, I will, in order, describe:

1. Existing evidence about the long term record of takeovers in general and why the evidence may not be useful in predicting the consequences of hostile takeovers.
2. Five of the more important claims and counter-claims about the short term consequences of hostile takeovers.
3. Approach I used to evaluate the claims.
4. Findings about the short term consequences of hostile takeovers. Here we will see that most critics' claims are not supported by the data.

5. Contrast between the short term consequences of hostile and friendly takeovers. Consistent with our finding in the last chapter that the expected benefits in the two types of takeovers are different, we will see here that hostile and friendly takeovers have different short term consequences as well.
6. Contrast between the short term consequences of pre- and post- junk bond era hostile takeovers. In the last chapter, we saw that expected benefits in pre-junk bond hostile takeovers had more in common with friendly takeovers in the post-junk bond era than with hostile takeovers. The same pattern we will see applies to short term consequences -- pre-junk bond hostile takeovers had short term consequences that were more like those observed after friendly takeovers in the post-junk bond era than those observed after hostile takeovers.

1. THE LONG TERM RECORD

It is hard to find a good word for the long-term consequences of takeovers. Every study that I am aware of shows that "performance" - as measured by a variety of accounting or strategic measures - usually deteriorates after a business is acquired.

To quote a few examples:

- o Ravenscraft and Scherer¹ who studied the post merger performance of 5000 acquisitions from 1950 to 1977 found that merger prone companies did less well in the businesses they acquired than in the businesses they built from within, and the longer they held on to the acquired businesses, the more returns deteriorated. Concluded the authors:

"Good companies were acquired and on average, their profits and market shares declined following acquisition. A smaller but substantial subset of those good companies experienced traumatic difficulties, triggering sell-off to non-conglomerate organizations that could manage them more effectively. There was considerable distress and wreckage on the road to conglomerate riches."

¹ Ravenscraft and Scherer (1985)

- o Dennis Mueller showed that acquisitions, especially of the conglomerate type, led to serious market share declines between 1950 and 1972, compared to a minimal merger control group.
- o Michael Porter² studied the acquisition record of 33 well regarded companies from 1950 to 1986 and found that "on average, corporations divested more than half their acquisitions in new industries and more than 60% of their acquisitions in entirely new fields... The track record in unrelated acquisitions is even worse -- the average divestment rate is a startling 74%."

These and other studies have been criticized on the grounds that the particular measure of "performance" used is not a true reflection of long-term economic value. Nor do the studies prove that takeovers cause poor performance - it is possible, as Ravenscraft and Scherer point out, that bidders acquire targets that have peaked and are destined to decline whether or not they are taken over. On the other hand the evidence does not strengthen the claim that efficiency is enhanced by takeovers. And it is instructive to observe that advocates of takeovers fail to cite studies that conclude that performance, as measured by any yardstick, is significantly improved after acquisition.³

The more important problem, as far as this investigation is concerned, is that the conclusions from studies of takeovers in general, may not be (for the reasons we discussed in the last chapter) germane to hostile takeovers. There is just one study - by Herman and Lowenstein⁴ (H&L) - that I have been able to find, that deals specifically with hostile takeovers, and its findings are ambiguous.

H&L studied all the hostile tender offers (including white knight rescues) that were initiated in the years 1975-1983 on which Compustat data was available. Their study of 56 transactions showed, that for the sample as a whole, the bidders' post acquisition profitability was as good as or better than their pre-acquisition profitability. The post acquisition profitability of those bidders who got into the takeover game after '81 was

² Michael Porter (1987)

³ Most post-takeover claims are based on the immediate reaction of stock prices to the acquisition announcement. It may be noted that ex-ante increases in stock values are not necessarily inconsistent with systematically poor ex-post performance - stock market values can rise even if a takeover is expected to have negative synergies, if the market had expected the acquirer to follow more destructive strategies.

⁴ Herman and Lowenstein (1985)

however precipitously lower than in the pre-acquisition period. This suggests to H&L that whereas in the 1970s, opportunities did exist to profit from takeovers, by 1981, the activity had become a fad that lacked real economic potential.

H&L's inference may reflect an extreme sample bias. By limiting their observations to those transactions on which Compustat data was available on the bidder, they excluded deals initiated by individuals like Carl Icahn or Sir James Goldsmith who operate through private partnerships or shell corporations, and now account for a significant proportion of takeover activity. In my sample of 1985 and 1986 hostile takeover attempts for example, meaningful Compustat data was not available on nearly two-thirds of bidders.

Including only bids by publicly held companies skews the sample towards takeovers that are more likely to be undertaken for managerial ("synergistic" or "portfolio") reasons rather than by expectations of turning around poorly managed companies. For example, in 1985, nearly all of "Compustat" hostile bidders expected "portfolio" or synergistic benefits, while only one was motivated solely by "restructuring" benefits. In other words, H&L probably selected those hostile transactions that have the most in common with friendly acquirers and, not surprisingly, reached conclusions that are similar to those reached by studies that have not focused on hostile transactions.

2. CLAIMS ABOUT SHORT TERM CONSEQUENCES

The H&L limitations are of necessity rather than oversight. As I mentioned in the Introduction, there are several reasons why it is infeasible to replicate Ravenscraft and Scherer type studies using a truly representative sample of hostile takeovers: the "restructuring" type of hostile takeover, does not yet have a long enough history; the F.T.C no longer publishes the data necessary to perform the industry segment analyses; and, many of the targets pass into the hands of owners who have no obligation to make

their results public.

A more realistic objective in evaluating the current crop of hostile takeovers is to investigate their short-term consequences, using where necessary, ad-hoc tests tailored to fit the available data.

The controversy between the pro- and anti-camps about the consequences of takeovers seems to revolve around five major sets of issues⁵: financial leverage, investment, divestitures, the quality of management and the "redistributive" consequences of takeovers. Let us discuss these in turn:

2.1 Financial Leverage

Corporations are severely hobbled, claim critics,⁶ by the excessive debt that is assumed to finance their acquisition. High interest payments have to be made at the expense of long term investments and can turn what would otherwise be a moderate downturn into a Chapter 11 bankruptcy filing.

Advocates like Jensen argue that targets may be under leveraged before they are acquired. Quite apart from their tax shield effects, higher debt levels can create real economic value especially in mature companies that generate high free cash flows. High interest payments force managers of such companies to operate their assets as efficiently as they can and to pay out the cash they cannot profitably invest, instead of frittering away potential profits in organizational inefficiencies or making frivolous acquisitions at inflated prices.

H&L's study comes down on the side of the critics. They found:

⁵ Critics' claims have mainly been drawn from testimony in Congressional Hearings (1987) on hostile takeovers. Advocates' claims have been drawn from Jensen (1986) and Poulson and Jarrell (1985).

⁶ See testimonies of Rohatyn (p. 43), Hills (p. 92), and Wheat (p. 106) in Hearings (1987).

- o The average target had a debt to equity ratio of over 70%, whereas the average manufacturing company debt to equity ratio in a comparable period was only 43%. Hence, at least by the standards of their peers, targets were not sub-optimally capitalized because they carried too little debt.⁷
- o The bidders incurred substantial, and in the opinion of H&L, dangerous levels of debt to finance their acquisitions. Coverage of fixed charges dropped by about 20% and did not materially improve even five years after the acquisition.

2.2 Investment

Critics claim that in order to recoup the premia they have paid, (and because so much of their cash flow is committed to servicing debt) acquirers stop investing for the future.⁸ Spending on capital equipment, R&D and the development of new products or markets is cut back and acquisitions are "harvested" for cash or short term profits.

Advocates counter that a rational acquirer has no incentive to forgo promising investment opportunities; profit maximizing acquirers cut only those investment projects that have negative net present values, usually in companies operating in mature industries that need to reduce capacity.

2.3 Redistribution Issues: Efficiency versus Equity

If stockholders gain through a takeover, critics argue, it is often at the expense of other parties who also have a legitimate stake in the corporation.⁹ Acquirers pilfer pension plans. Implicit and sometimes even explicit promises that have been made to employees regarding job security are broken. Suppliers and sometimes whole communities may be devastated.

⁷ Pound (1985) also found that targets of hostile takeovers tend to have as much leverage as non-targets.

⁸ See Drucker (1986) and Rohatyn (Hearings 1987, p 43)

⁹ See Schleifer and Summers (1987), and the testimonies of Baker (p 172), Howell (p. 191) and Sasser (p. 260) in Hearings (1987)

Advocates would regard some of the actions that follow a takeover as a redress of injustices previously suffered by shareholders. Workers in the past enforced illegitimate property rights over jobs and claimed wages that were considerably in excess of market rates. These rights and wages were ceded by managers who were breaching their fiduciary duties towards shareholders. Besides, an efficiently functioning market system requires periodic redeployment of resources, which in turn leads to unavoidable social disruption. Takeovers are, if anything, a relatively humane and efficient mechanism by which the redeployment of resources takes place. Without takeovers, many targets would slowly and painfully end in bankruptcy and much more social value would be destroyed.

2.4 Divestitures

Acquirers make a quick killing, complain critics,¹⁰ by dismembering companies. When the most valuable assets and businesses are sold off in a so called "bust-up", critical synergies are destroyed. Organizational morale plummets in the units that are spun off, as well as in the businesses that remain.

Unless the new owners of the pieces that are spun off are irrational, advocates of takeovers respond, value cannot be destroyed in a profitable break-up. In fact, acquirers create value when they unbundle conglomerates - the disparate pieces are transferred to new owners who can either realize synergies by combining the divested units with their existing businesses or can give the units their undivided attention. Splitting up conglomerates may also expose the chronic losses of certain businesses and induce greater efficiency in their operation.

¹⁰ See testimonies of Sommer (p. 95 and 113), and Clark (p. 100) in Hearings (1987).

2.5 Quality of Management

Experienced senior executives, it is claimed, who have managed their companies with the long term in view are replaced by carpet bagging speculators or empire builders who have no knowledge of the businesses they gain control of.¹¹ Consequently, long term performance deteriorates after a hostile takeover.

New brooms sweep clean, is the counter argument.¹² Executives conditioned by a certain environment (e.g. of continuous growth or strict regulation) and who have developed close personal ties to their organizations may not be effective when environmental changes (e.g. slower growth or deregulation) require radical breaks with the past. Besides, it is not always clear that the experienced executives who are replaced have a real record of having delivered long term results.

Another benefit claimed for takeovers is that they can lead to a better alignment of owner-manager interests. Senior managers of many large corporations, who own only a small percentage of the outstanding stock, may not be sufficiently motivated to act in the shareholder interest. After a takeover, the senior executives often have a significant equity stake in the company they are responsible for managing.

H&L's study provides some ammunition on this issue for takeover critics. They found that the targets of hostile takeovers had above average to excellent returns on equity. The average target earned a 16.4 percent R.O.E. one year before and a 17.1 percent R.O.E. two years before it attracted a takeover bid. Pre-acquisition R.O.E.s for targets were thus considerably in excess of the 12 to 13% R.O.E. earned by the average

¹¹ See Burck (1982) and testimony by Sigler (p 159) and Greenspan (p 25) in Hearings (1987).

¹² See Jensen (1986), and Senator D'Amato's comments in Hearings (1987 p 28).

U.S. company, and in 37 out of 56 takeovers, the target was more profitable than its acquirer. These numbers, note H&L, are inconsistent with claims that targets are badly managed and that bidders possess the skills to straighten them out.¹³

2.6 Demonstration Effects

Another dimension of the controversy goes beyond what happens to the companies that are actually acquired. Critics claim that managers of companies who have not yet become targets are induced to take defensive measures that are not in the long term interests of the corporation. They eliminate investments, sell off valuable subsidiaries and assume substantial debt before a raider comes along to harvest, divest and load up their companies with debt.¹⁴

If managers at large are frightened into behaving short-sightedly, says the opposite camp, it is because of ignorance about the true causes and consequences of takeovers. The only managers who need to worry about being taken over are those who invest in uneconomic projects, diversify into unrelated businesses and are unwilling to bear the unpleasantness of eliminating organizational inefficiencies. And, if such managers are reformed by the takeover threat, it is all to the good.

3. APPROACH TO ASSESSING THE CLAIMS

Besides the two H&L findings on leverage and quality of management, there is little research about the short-term consequences of hostile takeovers. The data is so scarce that not only do we not know whether the critics or the advocates of hostile takeovers are right, we do not even know whether they are arguing about significant issues. Therefore, in investigating rival claims, I first tried to determine whether the

¹³ H&L's conclusions about the quality of target managers is consistent with the research on friendly takeovers. For example, Steiner who reviewed the pre- 1973 evidence found that acquired firms were not below average performers in their industries. Scherer, Harris et al. found "acquired firms of the mid-1970s to be somewhat more profitable than population norms or non acquired company control samples."

¹⁴ See testimonies of Sommer (p. 102), Wheat (p. 106) and Smithburg (p. 224) in Hearings (1987)

controversies were hypothetical or real - for example, was high leverage the consequence of many takeovers, or did it follow only in a few isolated cases? Only if the issue appeared to be salient did I seek to investigate whether the evidence favored the critics' or the advocates' positions.

The sample for studying the effects of hostile takeovers was drawn from the 1985 and 1986 transactions that we looked at in the last chapter. It included the 20 contested takeovers (12 in '85 and 8 in '86) that were successful and eight cases where the target managers repelled raiders and retained control¹⁵ but excludes the contests which culminated in white knight rescues. The eight successful resisters were included because the evidence indicates they maintained their independence by committing to undertake the sort of "restructuring" that was urged upon them by their hostile suitors. The white knight cases were excluded because control passed into the hands of "acceptable" suitors whose commitments and post-takeover actions are more typical of friendly acquirers.

(The consequences of hostile takeovers in 1985 and 1986, I should note were usually quite similar; in the few cases where differences exist, the data has been broken out separately.)

This small number of 28 cases examined suggests that pending a larger sample study my findings should be regarded as being tentative. Further it should be noted that the data on the 1985 transactions is more reliable and complete than the data on the 1986 transactions since the data collection in this study was terminated in the spring of '88. A representative larger sample, I might add, was difficult to come by when this research was conducted -- very little time had elapsed since the 1987 takeovers, and hostile takeovers before 1985 were likely to contain a high proportion of "managerial" transactions that happened to be contested.

¹⁵ The five include a border line case - Uniroyal. Uniroyal's managers did repel Icahn by committing to a restructuring, but their control was not expected to be long-lived.

The analyses that I could employ were constrained by the type of information available. Soft descriptors had to be used instead of hard numbers since private acquirers do not make their financial statements public, and I did not, as H&L appear to have done, wish to purchase precision at the cost of representativeness. Furthermore, the issues themselves dictated the choice of "soft" variables and classification schemes; and, unavoidably, some judgements on the part of the researcher.

4. FINDINGS ABOUT HOSTILE TAKEOVERS

My analysis suggests that three of the issues that are debated are not very significant. Except in the very short term the raiders don't leverage themselves up dangerously; investment cuts (either of positive or negative NPV projects) are rarely induced by hostile takeovers; and hostile takeovers do not lead to significant economic harm to most target employees. Significant divestitures and changes in management teams are however induced by hostile takeovers.¹⁶ Let us consider these issues in turn.

4.1 Leverage

Our first task in establishing the significance of this issue is to establish a standard for what constitutes a "dangerous" level of debt. H&L's yardstick for measuring financial risk - debt equity ratios - is, I believe, simplistic. A firm with a high debt/equity ratio may not face a much higher bankruptcy risk than a firm with a lower ratio if it:

- o Has more stable and reliable cash flows.
- o Owns valuable assets like real estate (carried on its books at less than market value) which it can sell to raise cash in times of financial distress.

¹⁶ I did not look at "demonstration effects".

- o Has easier access to the stock markets. A firm which can raise new equity capital quickly can retire (or defease) the debt on which it may have difficulty making interest payments.

Many subjective factors including the "stability" of a firm's cash flows, the "true value" of its assets and its access to the stock market therefore have to be taken into account in determining true financial risk. As it happens, firms like Standard and Poor's and Dun and Bradstreet make a living assessing these factors and I used their bond ratings as the primary basis for determining the extent to which financial risk was increased in the course of a takeover. In some cases where no bond ratings were available, I relied upon the "Financial Strength" rating Value Line provides for the companies it covers.

Four categories were established to classify the increase in financial risk, as shown in Table 1.

**TABLE 1:
CLASSIFYING FINANCIAL RISK ADDED**

Risk Added:	Condition
None	Purchase was made for stock.
Low	No change in Moodys, S&P bond ratings (or Value Line Financial Safety rating).
Moderate	Ratings on debt lowered by Moodys or S&P, but not down to speculative grade. Or, Value Line rating lowered, but not below "satisfactory" grade.
Significant	Speculative grade debt issued; or ratings on existing debt lowered to speculative grade by Moodys or S&P; or Value Line rating lowered below "satisfactory" grade.

An analysis of rating changes shows that 56% of hostile takeovers led to a "significant" increase in financial risk. (See Table 2) If targets which remained independent are excluded, the proportion was even higher - 68%. On the face of it then, the addition of debt in hostile transactions is a significant issue that merits further investigation.

Table 2:

Extent of Financial risk added after hostile takeovers

Increase in Financial risk	Percent Takeovers in which observed		
	Successful Attempts (N=19)	Unsuccessful Attempts (N=8)	Total Hostile
Low to none	21	0	14.8
Moderate	11	75	29.6
Significant	68	25	55.5

If one looks beyond the immediate consequences of the transactions, however, quite a different conclusion emerges. For most hostile acquirers, junk bond financing was intended to be a stop gap measure. As Table 3 shows, asset sales, stock issues and innovative financing arrangements soon raised substantial funds for acquirers and put them on a more stable financial footing. In fact, only three hostile takeovers which used junk bond financing were not quickly followed by a reduction in financial risk.

A couple of caveats should be noted before we dismiss the issue of leverage as not being important except in the very short term. First, this analysis does not include the debt that may have been assumed by the buyers of the assets that were sold off by the

raiders. Second, most of the asset sales and stock issues took place when interest rates were falling and stock prices were rising. If interest rates had been rising instead, raiders might not have been able to pay down their debts as quickly as most of them did.

TABLE 3: FINANCIAL RISK REDUCTION AFTER TAKEOVERS

Target/acquirer	Funds raised after acq./ financial risk reduced by:
Crown Zellerbach/ Goldsmith	Sales of paper operations and other assets. After asset sales Moodys restored debt rating to pre-takeover level.
Am. Natl. Res./ Coastal Corp.	Coastal (new parent of ANR) greenmailed Sonat Corp. into buying its 8.5% 10 year debentures to retire the 15.2% debt incurred while buying ANR.
AMF/Minstar	Sales of 50% of assets, yielded virtually entire purchase price paid.
Revlon/Pantry Pride	Sales of most non-beauty care businesses.
Gt. Lakes Intl./Itel	Itel (new parent of Gt. Lakes) persuaded lenders to accept 1/3 rd. of interest payments in common stock
Informatics Genl./Sterling Soft- ware	Common stock issue (1986), sales of division, retirement of debt through cash flow.
Uniroyal Inc./ Mgmt. LBO	Liquidation of company
Frigitronics/ Revlon	Sales of division to J&J, yielded virtually entire purchase price paid.
Allied Stores/ Campeau	Sales of 16 of 24 stores; \$400m of equity issues

One of the 1986 takeovers did in fact unravel because a weak market thwarted the acquirer's plans to sell assets and pay down debt. Asher Edelman financed his acquisition of Ponderosa with loans that he expected to repay by selling off two subsidiaries. The smaller unit -- a Mexican restaurant chain -- was duly sold, and several buyers had been lined up for the larger unit -- a meat processor -- as well. Before the sale of the meat processor could be completed, however, the October 19 th. crash shook the

confidence of potential buyers. Unable to get the price for the subsidiary that he needed to pay back lenders, Edelman was forced to sell his interest in Ponderosa to Metromedia.

Nevertheless, as even the Ponderosa case indicates, it seems evident that raiders took on junk financing because they had to, and made every effort to reduce their interest obligations as quickly as they could. Usually, they succeeded. There is no evidence that the raiders believed high leverage was optimal for their enterprises in the long term.

4.2 Investment

Long term investment can be sacrificed for short term earnings or cash flow in many more ways than merely by cutting outlays on what accountants classify as capital expenditures. Long term "investment" in a business may consist of advertising, new product development, R&D and several other items that do not show up on a firm's capital stock, and a raider may "harvest" an acquired company by cutting back on any of these expenses.

A large amount of publicly available data was scanned in order to determine whether investment, broadly defined, was cut after an acquisition attempt. No effort was made to quantify the extent to which investment was cut (which would have been an impossible task); rather my objective was merely to determine whether there was any evidence at all of harvesting by the acquirer.

Evidence of cutbacks was found after only 7 (20%) takeover attempts in 1985 and 1986; in 65% of takeovers, no reports of cutbacks were found, while in the rest, the evidence indicates that investment may actually have been stepped up after the takeover. (See Table 4).

Table 4:
Changes in Investment Strategy Following Hostile Takeovers

Investments	Percent Takeovers in which observed		
	Successful At-tempts (N=20)	Unsuccessful At-tempts (N=8)	Total Hostile
Increased	15	12.5	14.2
Cutback	20	37.5	25.0
Unchanged	65	50.0	60.8

Not only is the proportion of takeovers followed by investment cutbacks small, it is not even clear that these cuts were due to takeovers. Of the seven takeovers in which investment cuts were either planned or implemented, four were in the oil (and oil related) industry. As is well known, there were extensive cutbacks in investment in exploration and development in the oil industry in after the precipitous fall in crude prices in the winter of '85. The cuts in the capital spending budgets of the four targets were not significantly different from those implemented by other companies in the industry.

In only three of the takeovers, does there appear to be a deliberate strategy of cutting back on long-term investment, that would not have occurred without a change in control, namely:

Pacific Lumber, reportedly facing a high debt burden, scrapped the "continuous yield" cutting process which had previously been followed and doubled harvesting of its redwood properties. This "dis-investment" in redwood was not dictated by changes in demand or competition.

Informatics General, according to Business Week, "had popular products and a

TABLE 5
CAPITAL SPENDING AND R&D EXPENDITURES OF TAKEOVER TARGETS
IN 1985 AND 1986

Target	Cash flow (\$ per share)	Cap spd (\$ share)/	Excess C.F (\$/share)	R&D/Sales
CBS Inc.	12.4	3.85	8.55	
Safeway stores	8.6	1	7.6	
Great Lakes Int'l	12.35	7	5.35	
Carter Hawley Hale	6.2	1	5.2	
National Gypsum	8.1	3.1	5	
Revlon	6.55	2.1	4.45	
Allied Stores	5.2	1	4.2	
McGraw Edison	9.65	6	3.65	1.5
SCM Corp.	11.95	8.66	3.29	1.5
Union Carbide	12.4	9.5	2.9	2.8
Amer. Nat'l Res.	12.15	9.25	2.9	
Ponderosa Inc.	4.7	2	2.7	
Gillette Co.	4.45	1.9	2.55	
Phillips Petroleum	13.8	11.5	2.3	0.7
Chesebrough Ponds	5.95	3.75	2.2	
Richardson-Vicks	3.34	1.16	2.18	3.1
Owens Corn. F'glass	8.61	6.51	2.1	
Informatics Gen'l	3.15	1.25	1.9	2.4
Cluett, Peabody	3.4	1.85	1.55	
Pacific Lumber	2.3	0.85	1.45	
Uniroyal	4.15	3	1.15	
Frigitronics	2.28	1.15	1.13	
Joy Mfg. Co.	2.7	1.75	0.95	
Unidynamics Corp.	3.95	3.05	0.9	
Tull (J.M.) Inds.	1.6	0.8	0.8	
Midcon Corp.	11.9	11.33	0.57	
NL Industries	1.97	1.5	0.47	2.6
Fruehauf Corp.	6.25	5.8	0.45	
AMF Inc.	2.7	2.3	0.4	4.3
Anderson Clayton	4.3	4	0.3	
Easco Corp.	3.05	2.8	0.25	
Sanders Associates	2.55	2.5	0.05	4.5
Southland Royalty	1.95	2.55	-0.6	
Mayflower Group Inc.	3.15	4	-0.85	
White Consolidated	5	6	-1	
Saga Corp.	4.3	6	-1.7	
Unocal Corp.	9.65	12	-2.35	0.6
Crown Zellerbach	6.45	9	-2.55	
Hammermill Paper	7.4	15	-7.6	

stable revenue stream of annual maintenance and support fees. So [the acquirer] scaled back development; cut employment by 40% and found new markets for existing products".

Owens-Corning Fiberglass. "In order to increase cash flow to service its debt", claimed Forbes in 1987,¹⁷ " the company has let go 480 of its 970 employees [and] slashed its research budget in half¹⁸... Projects Owens Corning has discarded include an attempt to develop combination materials of fiberglass and carbon for sales to the aerospace and strategic materials industry."

Now there may of course be slippage between the public record and investment cuts actually made. But, as Table 5 shows, most of the targets of hostile takeovers were not in high growth businesses that demanded much new investment. Cash flow generally exceeded annual investment needs, and most targets reported little to no R&D expenses. So even the opportunities for raiders to boost short term cash flow at the expense of long term investment were limited.

4.3 Redistribution Issues

In order to examine the proposition that gains to targets' stockholders or acquirers are achieved at the expense of the targets' employees, I examined the public record for evidence of any economic harm that may have been visited on employees after a takeover. Evidence of "redistribution" effects - layoffs, plant closings, withdrawal of pension plans - was found in about two thirds of hostile takeovers in 1985 and 1986. Thus, the redistribution issue, like the leverage issue, appears, on the first level of analysis, to be significant.

A different picture emerges however when the circumstances and extent of the

¹⁷ "What a Raider Hath Wrought", Willoughby, Jack, Forbes, 3/23/87 pp: 56-57.

¹⁸ According to Compustat however, OCF increased its research budget by 5% in '86 over its '85 level. (See: BusinessWeek, 6/22/87 p144)

apparent penalties imposed on target employees is examined. First we should note that large companies in the U.S. began reducing jobs about two to three years before raiders became a serious threat -- thanks to a severe recession in 1982 and a rising dollar, employment in Fortune 500 companies fell by 6% from 1981 to 1986. Companies like AT&T, Exxon and General Electric shed tens of thousands of jobs in the absence of any takeover threat. Consistent with the overall pattern, employment had been shrinking in most targets *before* they came under attack -- as Table 6 shows, on average, employment had fallen 7% between 1981 and 1985. And many of the targets that did report employment growth over the period appear to have attained the increase through acquisition of other businesses.

Second, in about half of the cases where redistribution effects were observed after a hostile takeover attempt, the evidence suggests that employment would have continued to decline with or without a change in control, because the targets and the industries they belonged to were facing severe profitability problems that bore no relation to the activities of the raiders.

CBS for example, was being squeezed (along with ABC and NBC) between rising costs on the one hand and declining viewership and revenues (resulting from competition from the cable industry) on the other. Uniroyal was suffering, along with other U.S. manufacturers, from excess capacity and foreign competition. The breakdown of pricing discipline within OPEC was hurting Unocal and Phillips and everybody else in the industry.

**TABLE 6: CHANGES IN EMPLOYMENT OF TARGETS
BEFORE TAKEOVER ATTEMPTS**

Target	Employment change 1981-1985	
	Percent of '81 work force	Total number of employees
NL Industries	-51.3%	-11910
White Consolidated	-45.3%	-11600
Amer. Nat'l Res.	-33.9%	-5600
Crown Zellerbach	-32.9%	-9332
CBS Inc.	-27.5%	-9789
SCM Corp.	-24.3%	-6700
Uniroyal	-23.5%	-5793
Great Lakes Int'l	-20.0%	-300
McGraw Edison	-16.5%	-5600
Phillips Petroleum	-15.1%	-5200
Revlon	-15.1%	-5300
AMF Inc.	-12.4%	-2636
Union Carbide	-10.8%	-11889
Gillette Co.*	-2.8%	-900
Pacific Lumber	0.0%	0
Allied Stores	0.0%	0
Ponderosa Inc.	0.0%	0
Carter Hawley Hale	1.8%	1000
Informatics Gen'l	3.8%	100
Southland Royalty	5.7%	30
Frigitronics*	8.3%	175
Easco Corp.	9.1%	460
Unocal Corp.	20.1%	3464
Owens Cor. F'glass*	21.4%	5100
Ryan Homes	28.0%	385
Saga Corp.*	52.5%	21000
Average	-7%	-2239
T-stat for hypothesis of no change	-1.5	-1.8

* Significant acquisition activity reported in the period.

Targets and non-targets alike in these industries, were responding to adversity by cutting employment and capacity in 1986 and 1987 -- Exxon, for example, which has never faced the hint of a takeover threat instituted a sweeping early retirement program, while many private wildcatters shut down operations altogether. The link between hostile takeover attempts and job losses in companies like Unocal, Phillips Petroleum, Crown Zellerbach and Uniroyal therefore seems tenuous.

In nine targets, an argument may be made that redistribution issues arose out of (rather than followed) takeovers - here it may be reasonably claimed that the target (or its industry) faced no imminent financial difficulties that would have forced the plant

closings and job losses that were reported in 1986 and 1987.

The magnitude of these effects however borders on the trivial. Compared to the average 7% job cuts that had already been made in the targets after 1981, in almost every case¹⁹, the "avoidable" job losses involved layoffs of a relatively small number of corporate and administrative staffs rather than the more numerous line or production employees. (See Table 7). Although accurate estimates are difficult to come by, on average, the administrative job losses were of the order of a few hundred jobs per target company. And the total employment loss "induced" by all significant hostile takeover activity in 1985 and 1986, we may estimate, was probably under ten thousand jobs.

TABLE 7

REDISTRIBUTIVE ACTIONS "INDUCED" BY HOSTILE TAKEOVERS

Target:	Pre- takeover employment	Reported layoffs, plant closings etc.
McGraw Edison	28,000	Some administrative employees laid off. Campbell chain production moved overseas.
AMF	36,000	Most (approx. 400) corporate staff laid off
SCM	20,900	Corporate level staff probably laid off, but no record available
Revlon	29,900	Took \$105 m from excess pension funds. Some corporate level staff probably laid off, but no public record available
Informatics Genl.	2,600	Approx. 100 staff laid off at headquarters, and, possibly another 100 programmers
White Consol.	14,000	900 laid off in 3 plant closings; however planned to add 500 in Webster City plant expansion
Ponderosa	20,000	Approx. 120 laid off at headquarters
Saga Corp.	64,000	Approx. 245 laid off at headquarters
Gillette	34,100	2400 layoffs announced; 1200 reported implemented by 5/88
O.C.F.	26,900	upto 5000 terminations planned
Total employees	276,400	

¹⁹ With the exception of Gillette and OCF.

4.4 Divestitures

It would have been desirable to obtain a quantitative measure of the extent of divestitures that follow an acquisition such as the ratio of the value of assets divested to the acquisition price paid. Such data is however not always available: in some cases, divestitures are made for an "undisclosed sum"; in other cases the target's assets are sold as a package with some of the acquirer's existing businesses, and only the value of the total package is disclosed; in yet other cases businesses may be bartered for other assets instead of being sold for cash. For example, after its acquisition of RCA, GE swapped a package consisting of RCA's and some of its own consumer electronics businesses for Thompson's medical electronic businesses (and some cash). It is therefore difficult to figure out from public data, the dollar price for which RCA's electronics businesses were sold.

Consequently I was forced to rely on a qualitative classification scheme. The extent of divestitures that followed an acquisition were classified as:

- o *Significant*, if about half or more of the target's businesses in terms of total sales were divested; or, if the acquirer recovered most of the price paid for the target through divestitures. This category was intended to cover "bust-up" acquisitions in which a diversified company is split up into its component parts.
- o *Significant, Attempted* if, as described above, a significant proportion of the targets' assets had, as of May 1987, been put on the block but their sale had not been completed.
- o *Low to None* if no assets had been divested as of May '87 or if the assets sold, or attempted to be sold, were unimportant constituents of the targets' enterprise -

say 10 percent or less of the targets' sales or acquisition price. This category was intended to cover those cases where divestitures were a minor by-product of post-takeover activity.

- o *Moderate*, if the extent of divestitures made (or attempted) after a takeover was neither significant nor low. This residual category was intended to cover cases where divestitures of reasonable sized units were made (because, for example, they were required by the Justice Department or because the divested businesses didn't fit the acquirer's portfolio strategy) but where there was no extensive split-up of the target.

Table 8 shows that "significant" divestitures were made or attempted after 60.7% of hostile takeovers, and moderate divestitures after 10.7% of takeovers. Unlike high acquisition debt, divestitures are not easily reversible; and unlike the investment or employment cutbacks, they were not 'induced' by product market conditions. So finally, after three red herrings, we finally have a real issue on our hands! And the question we have to investigate is whether value was created or destroyed due to the divestitures.

Table 8:

Extent of divestitures following hostile takeovers

Extent of Divestitures	Percent Takeovers in which observed		
	Successful Attempts (N=20)	Unsuccessful Attempts (N=8)	Total Hostile
Low to None	30	25	28.6
Moderate	10	13	10.7
Significant	60	62	60.7

TABLE 9: DIVESTITURES FOLLOWING HOSTILE TAKEOVERS

Seller/Unit sold**Crown Zellerbach:**

Headquarters Bldg.
Gaylord Cont. div.
Zellerbach dist:
- Zellerbach Paper
- Virginia Paper
- Southern Paper
- Office products

AMF Inc.:

Bowling Prods.
Specialty Mats.
Control Syst.
Long Mile Rubber
Tire Eqpt.
Potter & Brumfield
Paragon Elect.
Belkins Records

SCM Corp.:

Sylvachem
Durkee Famous Foods
Glidden Paint

Revlon:

Technicon Group
Adams Drug.
Norcliff Thayer
Drug and Pharm. Bus.
Devon Stores

Pacific Lumber :

Welding Divn.

Easco Corp.:

Hand Tool Divn.
Indust. Grate Div.

McGraw Edison:

63 % Int. in Onan

Informatics Genl. :

Inf. Legal Syst.
Insurance Syst.

Times Fiber:

Comm. Syst. Divn.
CATV switch mfg.
HQ and mfg. bldg.

Unocal:

Stake in Magma

Phillips Pete.

Coal & Geotherm. assets
O & G Int. in Calif.

Union Carbide:

Packaging Divn.
Polymers and Comp.
Battery Unit
Home & Auto. Prods.

CBS Inc.:

Musical Inst. Ops.
25% stake in Tristar
Book Publishing
SBK Ent. World

Uniroyal Inc.:

Tire bus.
Chem. Businesses
Plastics Co.
Rubber plantation

White Consolidated:

7 steel & Food eqpt. divs
140 acres + w'house

Saga Corp.:

Rest. Businesses
100 Straw Hut Pizza outlets
Headquarters Bldg.

Ponderosa:

Casa Lupita Rest.
ESI Meats Inc.
HQ Bldg+jet+art collectn.

N.L. Industries

Treating Chems. Divn.
Hycalog (drill bit mfg.)
Acme Tool Divn.
Schaffer Divn.
Chemicals Divn.

Frigitronics

Intraocular Lens Business

Allied Stores

Bonwit Teller
Jerry Leonard divn.
Miller & Rhoads Divn.
Pomeroy's Divn.
Joske's & Cain Sloan Divn.
Block's Inc.
5 Shopping Centers
Garfinkel
Donaldson Dept. stores
Catherines
Plymouth shops

Gillette:

Jafra Cosmetics
Elizabeth Grady sub.
Misco., cataloger
S.T. DuPont

Owens Corn. F'glass

Hitco
F.R.P.
F.R.P. Components
Mineral Prods. plant
Ladish Co. Inc.
Closed Plant, eqpt.
Foam Prods Plants
Performance Contracting Inc.
Ormet Stake

Carter Hawley Hale

2 stores in Denver
Neiman Marcus
John Wanamaker

Value could be destroyed when a firm is split up if there were synergies between the businesses rent asunder. Such synergies, may, broadly speaking, be classified into "operating" synergies -- economies realized by exploiting interrelationships between businesses -- and administrative or financial synergies -- the advantages that may be gained from managing even totally unrelated businesses under a single corporate umbrella. While we cannot, from the available evidence, make inferences about the latter kind of synergies, the record does suggest that the divestitures that followed hostile takeovers probably did not lead to the loss of significant "operating" synergies.

1. A case by case study (See Table 9) of the divestitures indicates that the units separated (or planned to be separated) served distinct markets with distinct products, and the loss of economies of scope or scale appears unlikely. Only in the case of the divestitures that followed the takeovers of Informatics General and Allied Stores does any claim of lost "business" (i.e. non financial) synergies seem tenable. The units sold from Informatics - Legal systems and Information systems served distinct customer groups but it is conceivable that they could have shared technologies and programmers. Likewise it is possible that the stores spun out of Allied might have enjoyed economies in joint purchasing.

2. The targets had diversified through acquisition and correspondingly, most of the divested units had not been developed from within. Out of the 81 businesses which were put on the block, the record clearly indicates that 66 had previously been acquired by the target; 12 had probably been previously acquired, but because of name changes, etc. it is difficult to absolutely sure; and only 3 had probably been internally developed. To the extent one can extrapolate from Porter's research about the difficulty of integrating

acquisitions²⁰ one would also infer that substantial synergies were not lost when the acquired businesses were spun off. In fact, if the targets had followed the pattern exhibited by the firms in Porter's sample, most of the divestitures undertaken after hostile takeover attempts, would have happened in the natural course of events. The main difference that may be attributed to hostile takeovers then is that they telescoped the divestitures into a short period, and they did not concurrently replace the units spun off with new acquisitions.

3. The speed with which most divestitures were accomplished -- usually within eighteen months of the takeover -- also suggests that the linkages between the businesses separated in the process were probably not great. It seems unlikely that if there was extensive sharing of facilities, coordination of sales, etc. the units could have been acceptably hived off to a seller. So even if operating synergies between businesses existed, in theory, it is unlikely that these synergies had actually been realized.

Hence we may surmise that the spin-offs resulted in the reversal of unrelated acquisitions and were unlikely to have caused the loss of operating synergies. For all practical purposes, the raiders seemed to be reversing past policies of unrelated diversification.

It is also worth investigating whether the divestitures resulted in a "net" increase in focus or whether the divested units simply fell into the hands of other diversified corporations. Although the data is not complete, on balance, it seems to suggest that hostile takeovers did not merely transfer businesses from one set of large diversified corporations to another. Of the 64 spin-offs for which we have data:

²⁰ As Porter (1987) puts it: "Even synergy that is clearly defined often fails to materialize. Instead of cooperating, business units often compete."

- o In 20 (31%) cases, the buyers were investment groups or the units' managers who intended to operate the business as a stand alone entity.
- o In another 26 (41%) cases, the buyers were single (or dominant) business companies who were in the same (or closely related) industry as the divested unit.
- o In the remaining 18 (28%) cases the buyers were companies who were following diversification strategies similar to those undertaken by the targets being split up. And, it is interesting to note, within the next year and a half, six of these buyers - Goodyear, Bell and Howell and Harcourt, Brace and Jovanovich, Federated Department Stores, John Blair and Carlson Pirie -- were themselves being courted by unwelcome suitors.

We may also observe that takeovers had the effect of transferring ownership of several businesses from publicly held targets to privately owned organizations. In 36 of the 64 spin-offs on which we have data, the buyers were private companies or partnerships.

Before proceeding, we should note that the data cited merely suggest that hostile takeovers did not destroy operating synergies. The facts do not tell us whether or not significant financial and administrative synergies were lost or what, if any, economic benefit was derived by unbundling diversified firms and transferring some businesses to private hands. Consequently we are not yet in a position to establish whether raiders perform a useful function in splitting up their targets.

Unfortunately, however, it seems unlikely that further empirical research, either now or in the future, will shed any light on whether the performance of businesses is actually improved as a consequence of the divestitures: consistent data is not available

and will not be available for a large number of the businesses sold to private entities. And even where data is available (e.g. for those private firms that have public debt outstanding or seek to return to public ownership) there are at least three obstacles to measuring the performance of divested units that will be extremely difficult to overcome:

- o The data (which is accounting rather than economic in nature) is usually contaminated by various write-ups and write downs of inventories, fixed assets and goodwill. It is no simple task to factor out these changes.
- o Performance has to be adjusted for industry effects. Studies of diversification like Rumelt's²¹ have been flawed by their failure to take industry and competitive factors into account.
- o The long term has to be taken into account. As Bower has pointed out, it is easy for a manager to improve profitability and cash flow in the short term by skimping on expenditures that really constitute long term investment. Therefore even short term improvements in performance were found, it would be difficult to judge whether or not lasting value had been added. If we were dealing with publicly traded companies we could assert that market prices factor in the long term; for our problem this fudge is not applicable.

Without hard data we have to turn to second best alternatives. In the next two chapters, using first principles and existing theory I will attempt to make the case that splitting up diversified companies and transferring businesses to private firms probably does create value. At this point however we cannot proceed beyond the negative result that the divestitures do not destroy operating synergies.

²¹ Rumelt (1974)

4.5 Quality of Management

To assess the significance of this issue, we first need to determine the extent to which incumbent managers are displaced as a result of hostile takeovers. As with the other issues, a qualitative classification scheme which could deal with the great variety of top management structures that exist in real companies was used. The extent of management change following a takeover was described as:

- o *Low*, if: all or most of those target managers described as "officers of the company" were retained; the target was maintained as a separate subsidiary with its own board of directors; and the composition of the board changed only slightly, to accommodate the new parent's nominees.
- o *Moderate*, if: only one or two "outsiders" added to the target's management team and/or the management ranks of the target were thinned.
- o *Significant*, if: several changes were made in the targets' management team or if the "corporate" management layer was completely removed, and the targets' board was dissolved or fully reconstituted.

According to this classification scheme there were significant management changes after seventeen of nineteen hostile²² takeovers studied in 1985. An entire corporate level of managers seems to have been wiped out or drastically pared back in the takeovers of Crown Zellerbach, AMF, SCM, White Consolidated, Saga, Frigitronics and Allied Stores as many of the constituent units of these companies were spun off and the corporate managers lost their *raison d'etre*. Significant changes in the key personnel were also made in most of the other targets with the possible exception of Great Lakes International

²² The analysis is limited to those targets that were actually taken over and excludes those cases where managements repulsed attacks by committing to a restructuring. It is worth noting however that in one of these firms - CBS - the CEO lost his job soon after the takeover attempt.

and Ryan Homes.

The normative question then arises, did these managers "deserve" to go, or did "good" managers lose their jobs? The evidence shows that the track record of the targets of hostile takeovers is mediocre when judged by the standards of:

- o *The targets' 4 year return on equity record, relative to their industry.*²³ 70% of the (41) targets of hostile takeovers had lower R.O.E.s than their industries - the average difference was -2.2%, (significantly negative at the 0.5 % level, $t=-3.3$) and the median difference was -1.9%.
- o *The targets' 5 year (risk adjusted) total stock return compared to that of the market as a whole.*²⁴ 75% of 20 targets of hostile takeovers in 1985 provided risk adjusted total returns to their stockholders that were lower than could have been earned by investing in a diversified pool of equities. The average difference between target and market returns was -4.0% (significantly negative at the 5% level, $t=-1.9$) and the median difference was -1.9%.

The 1986 targets did however have 5 year stock returns which were higher than market returns -- the average excess return was 6.5%. This result is not however statistically significant ($t=0.4$, 19 deg. of freedom) and the data is probably contaminated by the fact that the takeover game had heated up in 1985. Several of the targets were already "in play" as acquisition targets²⁵ and 1985 stock prices (which were used as the terminal prices in the return calculation) contained a takeover premium.

²³ Or, in cases where the target did not belong to a particular industry, average R.O.E. for publicly held companies, as reported by Value Line.

²⁴ Excess stock returns, by themselves, are not a good measure of managerial competence since low returns could merely indicate excessively optimistic prior expectations or exogenous changes in the target's business environment.

²⁵ For example U.S.A. Cafes had attempted to takeover Ponderosa in 1985 before Edelman made a successful offer in 1986.

- o *The opinion of their peers.* Fortune magazine's poll on the "quality of management" is available for 15 of the targets. In this poll the respondents associated with 32 industries²⁶ were asked to rate the quality of management of 10 companies in their industry. Each company was then ranked within its industry on a scale ranging from 1 -- the highest quality of management in its industry -- to 10, the lowest. Only 3 of the 15 targets was rated above a 6; three companies - Crown Zellerbach, Phillips Petroleum and Union Carbide drew a 10 rating; and the median rank was 7.

The question of whether hostile takeovers resulted in a transfer of control of the low performing targets into the hands of "better" managers is difficult to answer. As previously mentioned, nearly two-thirds of acquirers had no reliable public record of profitability or stock history from which inferences can be made about their competence. Besides, the question of the acquirers' management skills is moot, since, as we have seen, they usually sold many of the businesses they acquired to new owners.

About the only relevant observation that can be made in this regard is that, at least temporarily, hostile takeovers tended to transfer control from groups who had a low equity stake in their organizations to groups that had a high equity stake. As can be seen from Table 10 only 12% of hostile takeover targets had insider ownership exceeding 20%²⁷ of their total stock compared to 68% of their hostile acquirers.

²⁶ Such as executives, directors and analysts from the industry.

²⁷ "Insiders" were defined in the case of publicly held companies to be managers and members of the board of directors. In private partnerships or investment groups, the line between insiders and other "passive" investors is more difficult to draw since most investors play an active role in monitoring the enterprise. To accommodate this difficulty, I used a "high" (over 20%) category to classify insider ownership rather than estimating what could be a spurious percentage number.

TABLE 10

**INSIDER OWNERSHIP (1985):
HOSTILE ACQUIRERS VERSUS TARGETS**

Level of insider ownership	Percent of organizations	
	Hostile Acquirers (N=44)	Targets (N=42)
Low (less than 5%)	13.6	64.3
Moderate (bet. 5 & 20%)	20.4	23.8
High (greater than 20%)	65.9	11.9

The chi-squared statistic for independence was 29.7 with 2 degrees of freedom. Null hypotheses rejected at 0.5% significance

5. CONTRAST WITH FRIENDLY TAKEOVERS

A major reason for doing in depth analyses on the relatively small number of hostile takeovers that take place was my assumption that such takeovers are qualitatively different from run-of-the-mill friendly takeovers. Some indication of this difference came through in our investigation of the nature of benefits expected by hostile and friendly acquirers. Further insight may be gained by comparing the short term consequences of the two types of takeovers.

5.1 Leverage

Table 11 compares the extent of financial risk added immediately after successful hostile takeovers with that added after a randomly selected sample of friendly takeovers.²⁸ Unlike hostile takeovers, a majority of which were financed with high risk debt, 64% of

²⁸ The sample of friendly takeovers studied consisted of the same 30 takeovers that were investigated in the last chapter. It may be recalled that 8 of these involved white knights; no real changes in the findings below would result if the white knight deals were deleted.

friendly takeovers resulted in the addition of little to no financial risk - payment to target shareholders was made with the acquirer's stock or excess cash rather than by raising much new debt.

TABLE 11
INCREASE IN FINANCIAL RISK:
HOSTILE VERSUS FRIENDLY TAKEOVERS

Increase in Financial risk	Percent Takeovers in which observed	
	Hostile Takeovers (N=27)	Friendly takeovers (N=28)
Low to none	14.8	64.3
Moderate	29.6	14.3
Significant	55.5	21.4

The chi-squared statistic for independence was 13.1 with 2 degrees of freedom. Null hypotheses rejected at 0.5% significance

This mode of financing lends further credence to the possibility that managers' pursuit of "financial self sufficiency" was behind many friendly takeovers. As we discussed in the last chapter, acquisitions can "protect" managers from potential interference by the capital markets, by diversifying the acquiring corporation's profit and cash flow base. Financing an acquisition with debt reduces this protection since some of the cash generated by the acquired business has to be applied to interest payments. With stock financing on the other hand, financial self sufficiency is more assured, since no cash has to be paid out by the acquirer either at the time of the transaction or afterwards.

5.2 Investment

Table 12 shows that far fewer investment cutbacks followed friendly takeovers, and a higher proportion were followed by increases in investment.

TABLE 12
CHANGES IN INVESTMENT STRATEGY:
HOSTILE VERSUS FRIENDLY TAKEOVERS

Change in investment strategy	Percent Takeovers in which observed	
	Hostile Takeovers (N=28)	Friendly takeovers (N=28)
Investment increased	14.2	35.7
No change	60.8	60.7
Investment cutbacks	25.0	3.6

The chi-squared statistic for independence was 7.1 with 2 degrees of freedom. Null hypotheses rejected at 2.5% significance

The greater propensity of friendly acquirers to increase investments probably reflects the more attractive growth prospects of their targets. Table 13 compares the five-year sales growth rates of friendly and hostile targets expected by Value Line before the acquisitions were announced. It shows that over 60% of friendly targets had expected sales growth rates in excess of 10%, compared to less than 13 percent of hostile targets. The difference of mean growth rates between friendly and hostile targets was 4.6% (10.6% - 6%) which is significant at the 0.5% level ($t=3.8$, 48 d.f.).

TABLE 13
EXPECTED SALES GROWTH RATES:
HOSTILE VERSUS FRIENDLY TAKEOVERS

Expected Sales Growth	Percent Takeovers in which observed	
	Hostile Takeovers (N=17)	Friendly takeovers (N=12)
"High" (>10% p.a.)	13.0	75.0
"Moderate" (bet. 5 & 10%)	50.0	12.5
"Low" (<5% p.a.)	37.0	12.5

Average expected growth 6.0% 10.6%
t-statistic for equality of means = 3.8, 48 d.f.

Similar results are reported by Morck et al. from their analysis of 40 hostile and 42 friendly takeovers in the period 1981-1985. They found that friendly targets were younger, faster growing (as measured by employment), and reinvested more of their income than hostile targets.

The differing growth prospects of hostile targets compared to friendly targets is probably not an accident. High growth companies may not be subject to hostile takeover attempts for several reasons. First, high growth companies may be perceived to be more dependent on the talents of their existing personnel and raiders may see no point in acquiring such companies after alienating their managers. The value of low growth companies may not be perceived to be in as much jeopardy if the incumbent managers leave.

Second, founder-managers of high growth companies often own a large enough block of stock to defeat a hostile takeover attempt; mature low-growth companies are more likely to have passed the phase of being managed by founders who own a controlling interest.

Third, high growth companies are difficult to value. They sell at high multiples to

current earnings and book value, indicating that most of the value is based on profits that will be earned in the distant future. The great uncertainties inherent in valuing these future profits may be unappealing to the typical entrepreneurial raider, who the evidence suggests, is a hard-headed profit motivated individual interested in the here and the now. Furthermore, the low ratio of hard assets to market price of the target makes it difficult for the raider to finance a takeover with borrowed funds. In contrast, the typical friendly acquirers, motivated by managerial theories and objectives, may be less concerned about "overpaying" for growth; and, being able to make acquisitions for stock, they don't have to worry about the lack of target "collateral".

5.3 Redistribution Issues

Table 14 shows that redistribution was even less of an issue in friendly than in hostile takeovers.

TABLE 14
INCIDENCE OF REDISTRIBUTION ISSUES:
HOSTILE VERSUS FRIENDLY TAKEOVERS

Incidence of redistribution issues	Percent Takeovers in which observed	
	Hostile Takeovers (N=28)	Friendly takeovers (N=28)
None reported	32	68
Some evidence	68	32

The chi-squared statistic for independence was 7.9 with 1 degrees of freedom. Null hypotheses rejected at 0.5% significance

We have seen previously that the high incidence of layoffs and plant closings that follow hostile takeovers reflects the ongoing decline in the fortunes of the target firms.

Similarly, we may infer that the lower job losses in friendly takeovers reflect the same factors that were probably behind the higher occurrence of investment increases - the hostile raiders have a natural tendency to go after mature businesses with low growth prospects and declining employment whereas friendly acquirers are more likely to seek targets that are expected to enjoy high growth opportunities.

5.4 Divestitures

As Table 15 shows, significant divestitures (or attempted divestitures) were made after only 11% of friendly takeovers compared to 60% of hostile takeovers. This difference too reflects the differing nature of the targets. 75% of friendly targets were single business companies, compared to only 25% of hostile targets. Focussed targets probably "fit" the corporate strategies of "portfolio" and "synergy" motivated acquirers since they were less likely to contain incompatible businesses than diversified targets. In contrast, "restructuring" hostile acquirers, as we have seen, were in the business of buying and dismantling companies and would not have much interest in single business companies.

TABLE 15
EXTENT OF DIVESTITURES:
HOSTILE VERSUS FRIENDLY TAKEOVERS

Extent of divestitures	Percent Takeovers in which observed	
	Hostile Takeovers (N=28)	Friendly takeovers (N=28)
Low to none	28.6	71.4
Moderate	10.7	17.9
Significant (includes attempts)	60.7	10.7

The chi-squared statistic for independence was 13.7 with 2 degrees of freedom. Null hypotheses rejected at 1% significance

Therefore, while the activities of hostile acquirers resulted in bringing more focus to companies, the activities of friendly acquirers, especially of the "portfolio" variety, reduced it.

5.5 Quality of Management

Table 16 shows that far fewer "significant" management changes were made after friendly takeovers than were made after hostile takeovers. Target managers, this shows, had, at least in the short term, good reason to fear acquirers motivated by "restructuring" profits more than acquirers pursuing "portfolio" or "synergistic" objectives.

TABLE 16
EXTENT OF MANAGEMENT CHANGE:
HOSTILE VERSUS FRIENDLY TAKEOVERS

Increase in Financial risk	Percent Takeovers in which observed	
	Hostile Takeovers (N=19)	Friendly takeovers (N=27)
Low to none	0.0	51.9
Moderate	10.5	22.2
Significant	80.5	25.9

The chi-squared statistic for independence was 19.4 with 2 degrees of freedom. Null hypotheses rejected at 0.5% significance

Managers of the targets of friendly takeovers, Table 17 shows, were more likely to have better performance records than managers of hostile targets. This indicates that friendly acquirers prefer well managed companies which do not require turning around, which further suggests that friendly transactions are less likely to lead to improving the quality of management of the targets.

Table 17 also indicates that managers of friendly targets had higher equity stakes than managers of hostile targets. Recalling our finding from the previous chapter that friendly acquirers own a much lower share of their companies' stock than hostile acquirers, we may infer friendly transactions are less likely to transfer control into hands that have a stronger economic interest in the success of their enterprises.

TABLE 17
PERFORMANCE AND OWNERSHIP CHARACTERISTICS:
OF TAKEOVER TARGETS

Characteristic	Mean of sample		t-test for diff. of means (degrees of freedom)
	Hostile Targets	Friendly targets	
Target R.O.E. - Industry R.O.E.	-2.2	3.4	-3.2 (52)
Target 5 yr. stock returns - market returns ²⁹	-4.0	18.3	-4.39 (29)
Percent of stock held by insiders	6.6	15.6	-1.6 (61)

Similar results are to be found in Morck et al.'s analysis. Hostile targets, they discovered, had significantly lower Tobin Q ratios (the ratio of the market value of the firm to the replacement costs of the firm's assets) than friendly targets, from which they inferred that hostile targets are poorer performers than friendly targets. Morck et. al. also found evidence that managers of hostile targets also had a lower equity stake - on average the top two managers of hostile targets owned 3.2% of the stock of their firms, compared

²⁹ Includes only '85 hostile targets.

to 14.5% owned by managers of friendly targets; and, only ten percent of hostile targets were managed by founders or members of the founding family as compared to forty percent of friendly targets.

6. CONTRAST WITH 1981 TAKEOVERS

The short term consequences of takeovers in 1981 were investigated using the same sample of transactions that we looked at in the last chapter. The size of the sample is really small (5 hostile transactions and 8 white knight rescues), so the reliability of the inferences is low. The data suggest, albeit weakly, that the consequences of hostile transactions in 1981 were more like those of friendly transactions in 1985 than of hostile transactions.

- o Leverage was not a significant issue. Only one of the the 13 transactions was (temporarily) financed with speculative grade debt.
- o Only in the case of Marathon Oil (and to a lesser extent Conoco) was a takeover followed by a reduction in investment. Investment was increased in 6 of 13 takeovers.
- o Significant divestitures were reported after only 2 of 13 takeovers
- o Significant management changes were reported after only 5 takeovers.

And, the long term record of the 1981 takeovers (only one of which was motivated by restructuring) is consistent with the poor performance that is usually reported of takeovers in general. As Table 18 shows, 7 of the 12 synergistic and portfolio mergers ended either with the target being spun off or the erstwhile hunter becoming the quarry of another raider.

TABLE 18: 1981 "FAILED" (?) ACQUISITIONS

Transaction:

Garfinkel Brooks/ Allied Stores	Allied acquired in hostile deal by Campeau who sold the Brooks divn.
Magma/ Natomas	Natomas acquired by Diamond Shamrock in a hostile transaction.
Buffalo Forge/ Ampco Pittsb.	After years of losses, in Oct. '86, Ampco announced it was studying the sale or closure of Buffalo Forge.
Fisher/ Allied Corp.	Allied spun off its "unattractive" businesses (including Fisher) into Henley. In March '86, Henley spun off an interest in Fisher to stockholders, after taking a \$200m charge against earnings.
Hobart/ Dart & Kraft	Major divn., Kitchen Aid was divested in '85. The remainder of Hobart was later spun off, along with other units into a new entity.
Sunbeam/ Allegheny	Under attack (and after the Chairman was forced out of office under charges of corporate waste), Allegheny decided to go private in March 1987.
Marathon/ U.S. Steel	U.S. Steel received a hostile offer from Carl Icahn who wanted to divest its oil holdings.

7. SUMMARY AND CONCLUSIONS

We now have a relatively clearer picture of the raiders and their activities. Hostile acquirers in recent years have been free lance operators, not managers. They have usually bought low growth companies with poor track records that have diversified into unrelated businesses and sold off the pieces at a profit. Junk bonds have been extensively utilized but only as temporary, "bridge financing". The direct effect on jobs and long-term investment has been marginal, since the targets have usually been in mature or declining businesses. The principal long-term effect of hostile takeover seems to have been to induce greater "focus" in American industry by transferring assets from diversified corporations to single business entities. To a lesser extent, raiders have also helped transfer the ownership of assets from public to private companies and investment groups.

Friendly takeovers, the data suggests, represent a very different phenomenon. Managers, not entrepreneurs have been in charge. Their expectations have been of advancing a portfolio strategy or realizing synergies, and thus, perhaps, also promoting

managerial self sufficiency goals. Their targets have been healthy, expanding and relatively focussed companies. Significant increases in debt have been avoided and many deals financed by stock issues. Since the acquisitions have often been seen as growth vehicles, investment has actually been increased after many a takeover. And since takeovers have often represented "diversification" moves for the acquirer, focus has been decreased, rather than increased.

Finally, we may note that hostile takeovers, before the junk bond era had more in common with hostile takeovers than with friendly takeovers, including a high failure rate.

While these analyses suggest that most criticisms of hostile takeovers are not consistent with the data, they have not told us whether hostile takeovers make any positive contribution. Specifically, we have not yet evaluated whether or not the two principal consequences of hostile takeovers -- the unbundling of diversified firms and the transfer of businesses -- produce economic benefit. The next two chapters are therefore devoted to this assessment.

Chapter 4: Reversing Corporate Diversification

The most facile judgement of the raiders' activity is that if splitting up diversified companies is profitable, then it must be creating value. Unless buyers are overpaying or target shareholders are selling out at too low a price¹, the diversified form must be, at least for the companies taken over, less efficient than the undiversified. How else could a "bust-up" -- to use the popular term -- be profitable?

The argument, although logical, raises several questions. How do we know buyers and sellers are being rational? Why were the diversified corporations put together in the first place, and why did they survive for so long - what's different now? Is the public diversified form "wrong" only for that relatively small number of companies that are taken over, or are the divestitures by the raiders symptomatic of a more fundamental shift?

Although the possibility of irrational buyers and sellers cannot be ruled out, I will argue that the breaking up of diversified corporations by raiders does, very likely, have a sound economic basis, and represents a significant development that all large firms have to come to terms with. Specifically, I will seek to advance the following propositions in this chapter:

1. The diversified firm has significant economic advantages and disadvantages over the undiversified firm -- bust ups matter.

¹ And provided there are no negative externalities.

2. The increasing sophistication of capital markets has eroded the advantages of diversified firms. The diversified corporation is no longer the valuable institution it might once have been -- its disadvantages -- in general, not just for the firms that happen to be targets - may now outweigh its advantages.
3. Investor power, which has grown alongside capital market sophistication, has circumscribed managers' powers to maintain an inefficient organizational form. Therefore attacks on diversified corporations are not isolated accidents -- bust-up takeovers are an important step in the evolution of U.S. industrial structure.

Let us consider these in turn.

1. ADVANTAGES AND DISADVANTAGES OF DIVERSIFIED FIRMS

1.1 Two Key Differences

Although a diversified corporation contains units that are capable of existing as independent firms, it is more (or less!) than the sum of its parts. A \$10 billion diversified corporation is different from ten \$1 billion independent firms in two important respects.

One set of differences derive from the mere fact of common ownership. The dealings of stockholders, lenders, the IRS, employees, suppliers and customers with a diversified firm are affected by the aggregated fortunes of its constituent businesses. Therefore, the tax liability of a diversified corporation may be more or less than the sum of the liabilities of an equivalent set of independent companies. Likewise, the risk faced by suppliers in collecting their receivables or the danger employees perceive of being laid off may be different for a diversified corporation than for a single business entity.

Differences also arise due to an additional administrative layer (or layers) that exists

in a diversified corporation. Whereas the managers of an independent business are directly answerable to their owners, managers of the business units of a diversified corporation report to a corporate or general office. Executives and their staffs in the corporate office perform functions that would otherwise be performed by the external capital markets - like stock analysts they evaluate and monitor the performance of units; like stock or bond underwriters, they evaluate funding proposals and make resource allocation decisions; like a commercial bank, they offer cash management services; and, like the venture capitalists who sit on the boards of companies they have investments in, they offer strategic advice. In Williamson's² terms, therefore the corporate office constitutes an internal capital market.

In theory, the corporate office may also try to coordinate the functional or "operating" resources of the units under its wing in order to achieve economies of scale or scope. This role is not however of much interest here for two reasons. First, as we have seen, the typical targets of hostile takeovers tend to have heterogeneous units where the potential for realizing operating synergies is low. Second, it is not clear that even in firms where such potential does exist, it is taken advantage of. As Salter and Weinhold³ note, while operating synergies are "widely trumpeted" as a benefit of diversification, they are rarely achieved because they require "significant changes in the company's organizational format and administrative behavior" which are difficult to come by.

In fact, most large corporations have come to insist upon an arms length relationship between their units. They have learned that whatever benefits that might be gained by coordinating the activities of multiple units (such as the economies of scale in production or purchasing) are more than offset by internecine bickering, delays and the difficulty of allocating costs and revenues. Consequently over 80 percent of large and

² Williamson (1975)

³ Salter and Weinhold (1979)

medium sized firms are organized into independent "strategic business units" or profit centers⁴ which have limited dealings with each other -- Vancil⁵ found that only 27 percent of the firms he surveyed reported inter-unit transfers that exceeded 15% of their total transactions.

And the transactions which do take place between units are often conducted as if they were between independent firms -- Vancil⁶ reports that 53% of the firms in his sample mandated "market based methods" of transfer pricing between units.⁷

Therefore in this chapter when we talk about diversification and diversified companies we will be referring only to "unrelated" diversification.

The two differences that are important here -- common ownership of multiple businesses and the operation of an internal capital market -- lead to certain advantages and disadvantages for the diversified form. Let us see how.

Advantages of Common Ownership

The most obvious advantage has been discussed in a previous chapter -- ownership of multiple businesses allows a diversified firm to transfer cash from units with excess funds to units facing cash deficits without the tax payment that might result if the transfer were to be effected between two independent companies.

Diversification may also provide "insurance" benefits by pooling the fortunes of unrelated businesses and thus reduce the consolidated entity's unsystematic risk.

Lower unsystematic risk may lead to lower capital costs. If investors cannot easily diversify away such risks on their own, they might look to conglomerate firms for such

⁴ Reese and Cool (1978) found that about 93 percent of Fortune 1000 firms are organized into profit centers; slightly lower numbers are reported by Vancil (1978) and Tang (1979).

⁵ Vancil (1978 p176)

⁶ Vancil (1978 p120)

⁷ These rules of engagement are apparently taken seriously - business folklore includes many stories of entrepreneurs profiting by "buying oil from the 18 th. floor of Exxon and selling it to the 33rd. floor" or by "establishing a swap with Citibank New York on one side and Citibank Tokyo on the other".

insurance, and, in return, provide equity or debt financing at a lower cost than they would to a single business firm.

Lower unsystematic risk may also help the diversified firm reduce its cost of "human capital". The assets of a firm, it is widely recognized, include the skills and experience its employees develop through their continued association with the organization. Some of these skills are "firm specific" i.e. are "imperfectly transferable across employers". For example, IBMers knowledge of "how things get done around here" is of great value to IBM but may be of limited use to other employers.

Now, as Bhidé and Stevenson⁸ have argued, each firm must, in one way or another, pay for its own firm specific skills.⁹ Making a full, up-front cash payment is risky - unlike physical capital, human capital cannot be alienated, and it is difficult for a firm to ensure that an employee paid to develop skills today will wholeheartedly utilize those skills for the benefit of the firm in the future. Instead firms can more prudently make a number of implicit commitments to reward employees as they deliver on their skills in future periods.

These rewards, which might include favored promotion opportunities, and job and income security, are vulnerable to the same accidents that can jeopardize dividend checks. Therefore, all other things being equal, employees will put greater store by the promises of firms whose fortunes are not dependent on a single businesses, and a diversified firm will enjoy a comparative advantage in contracting for its specific human skills.

The argument is easily extended to relationships with suppliers and customers, who may also have to make "specific investments" which put them at risk. G.M.'s suppliers for example, may have to invest in molds for stamping out parts that only G.M. will buy

⁸ Bhidé and Stevenson (1986)

⁹ Since, by definition they are of value to no one else.

and likewise Lotus's customers may invest in developing applications for its 1-2-3 software. These investments may be more readily made by the customers and suppliers of diversified firms that are perceived to be less exposed to unsystematic risk.¹⁰

Advantages of Common Ownership

One disadvantage of common ownership is the moral hazard that arises from risk pooling. As Arrow¹¹ has pointed out, insurance schemes tempt individuals to take advantage of others in the group: If I buy health insurance, and if the insurance company cannot effectively discourage unnecessary visits, I have an incentive to see a doctor more often than I otherwise would. Since most other participants are faced with the same temptation, total benefits paid for doctors visits may sky-rocket. And high benefits may lead in turn to higher premiums, inducing some participants to drop out of the scheme.

Similar problems may undermine the risk pooling benefits expected of the diversified corporation. Consider for example, a company whose chronic losses in the steel business are offset by the profits of its energy division. Workers and managers of the steel subsidiary may be less willing to accept the painful adjustments necessary to restore profitability of their unit as long as the corporation as whole is in the black, than they would be if they belonged to a stand-alone money losing enterprise.

Employees of the healthy energy division on the other hand will have an incentive to withhold contributions to the parent corporation, by hiding potential profits in organizational slack or marginal investments. Or, if they can, employees of the profit making entity may simply quit. For example in early 1988 several of the top professionals in the Mergers and Acquisitions area of First Boston left to start their own operation

¹⁰ We should note that the advantage the diversified firm potentially enjoys in contracting with its stakeholders may not be realized if it has previously been unwilling to draw upon the resources of healthy units to meet commitments made by units in trouble. If a diversified corporation is perceived to be a loose federation of businesses committed to a policy of "each tub on its own bottom", then stakeholders are likely to deal with each business as if it were a stand alone entity.

¹¹ Arrow (1971)

because they believed the profits generated by their department were being unfairly used to subsidize the trading operation.

Risk pooling also poses agency problems. Top managers, like other stakeholders who invest in firm specific skills, have an interest in reducing the unsystematic risks faced by their firms. They can legitimately claim that their firms' diversification is a necessary part of their compensation package.

The self dealing problem arises because top managers have considerable discretion in determining their own 'diversification compensation' and their principals, the shareholders, cannot determine whether this is excessive or not. Whereas out-of-line cash compensation may be flagged by salary surveys, there are no external or market guidelines to indicate how much diversification represents fair compensation for a given level of firm specific investment. In fact, such investment cannot even be objectively measured. Only the managers can make the subjective judgements as to the insurance against unsystematic risk needed by their firms to develop long term relationships with suppliers, customers, other employees and the managers themselves. Under the circumstances, the temptation to deliberately over-estimate the need for diversification is high, especially since diversification may further other managerial goals such as growth and independence from shareholder interference.

Advantages of Internal Capital Markets

Internal capital markets of diversified firms, according to Williamson¹², enjoy an informational advantage over external capital markets: Unit managers cannot hide embarrassing facts from their bosses in the corporate office as easily as they can from outside shareholders. They are required to prepare voluminous monthly or quarterly reports, which they cannot easily doctor because unit controllers often report to the

¹² Williamson (1975)

corporate offices rather than to unit managers. And if corporate executives are dissatisfied with the information they routinely receive, they have the right to demand more. In contrast, outside investors may have to file suit to force the managers to produce something as innocuous as a list of shareholders.

Internal capital markets may also be better suited to handle sensitive data. Whereas a firm cannot easily prevent information provided to outside investors from falling into the wrong hands, data provided to the corporate office may be expected to stay within the firm.

The hierarchical nature of internal capital markets may also allow them to act more effectively on the information they possess. At least in theory, the executives of diversified corporations possess great power -- the CEO has the right to add or withhold resources from units, change their policies, or even fire their managers. External investors are rarely organized to wield such authority; consequently they may individually know what needs to be done but may find it difficult to act collectively to force the necessary changes.

Superior knowledge and the power to act may give internal capital markets an advantage in:

Evaluating investments designed to yield "first mover advantages". Suppose a firm invents a widget which promises to be very profitable as long as competitors don't quickly imitate the product, allowing the inventor time to build market share. If the firm wants to raise funds from outside investors to develop the widget, they may demand information which if leaked would destroy the value of the project. If however, the firm is a subsidiary of a diversified corporation, the project can be evaluated by the internal

capital market without compromising its confidentiality.¹³

Preventing a business which throws off surplus cash from reinvesting its profits in marginal projects. Donaldson's¹⁴ research suggests managers have a strong bias for reinvesting cash, even where shareholders might have more attractive opportunities outside the firm. The superior monitoring and disciplinary capabilities of the top officers of a diversified corporation may enable them to better extract cash from constituent businesses that do not face attractive investment opportunities and prevent value destroying investments than outside investors.

Problem solving. Outside investors face great handicaps in identifying and correcting problems in the companies they own. In the best of times, many managers view stockholders with suspicion and are reluctant to divulge more information than is strictly necessary. If things are going badly, they may clam up entirely. In contrast, the detailed reports that corporate executives receive may be expected to flag signs of trouble more quickly. And, as has been mentioned, the CEO of a diversified corporation can (at least in theory) intervene quickly, to change personnel or policies whereas shareholders may not be able to force change unless the problem really comes to a head.

Providing managerial assistance. The internal capital markets may have an edge not just in times of crises, but in providing ongoing managerial assistance as well. Suppose for example, that there is a manager, say a Harold Geneen, whose talents - in controlling costs, or consumer marketing or making astute technological bets - cannot be fully utilized by any one firm or even industry. Such an individual could be retained by investors to sit on several boards of directors but his effectiveness as an outsider might be limited. As a CEO of a diversified corporation however, such an individual might be

¹³ We should note however, that funds are raised from external capital markets for "general corporate purposes" quite regularly. Apparently, if a firm has established a reputation for using funds wisely, inability to provide full disclosure may not be a serious problem.

¹⁴ Donaldson (1984)

better positioned to implement his ideas.

The same argument can obviously be extended to include a management team or function whose skills cannot be fully utilized by a single firm.

Advancing short term credit. "Many large companies", write Salter and Weinhold¹⁵, "can achieve significant savings from centralized cash management. The potential benefits are particularly great in the unrelated diversified firm. With its operations at different levels of production and in different stages of seasonal or business cycles, the diversified corporation through centralizing cash balances can act as the banker for its operating subsidiaries. By being the banker the corporate office can route cash from units with a surplus in relation to their operating needs to those units in deficit and, in doing so, reduce the need of the diversified company (relative to the needs of its company's businesses) to purchase working capital funds from outside sources."

But why should a corporate office playing banker be more efficient than the real thing? Again, the assumption must be that the corporate office has informational and disciplinary advantages over "outside" financial institutions. It can do better "credit analysis", monitor "loans" more carefully and has greater power to recover funds.

Disadvantages of Internal Markets

The advantages of internal capital markets, the discussion above suggests, arise from the power that is concentrated in the corporate office -- the CEO's demands, for information or action, are more readily obeyed than similar demands made by outside shareholders.

The concentration of power however, comes at a cost. The corporate office may suffer from several disadvantages including:

Slow reaction time. The value added by corporate staffs has to be weighed against

¹⁵ Salter and Weinhold (1979, pp 139-40)

the direct and indirect costs imposed by the additional layer of management. Decisions made by unit managers which might otherwise be quickly approved by an independent firm's board (or which might not go before a board at all) may be scrutinized by several corporate employees. For example, in a diversified company, investment proposals typically have to be approved by seven levels of management.¹⁶ The additional scrutiny may weed out poorly conceived initiatives, but may also delay projects where speed is of the essence.

High overhead. Corporate second guessing can be expensive as well as slow. The average fully loaded cost of a corporate employee is estimated to be between \$75,000 and \$100,000 per year; the total costs of a typical 300-400 person staff therefore can range between \$20-\$40 million in a year.¹⁷

Limited range of investments. Whereas the diversified company may be better than the external-capital market at extracting excess cash from individual businesses, it may be at a disadvantage in investing this cash. The bias towards reinvesting in existing businesses applies to diversified corporations as much as it does to focussed companies - corporate officers are more likely to fund investments in existing units (or perhaps make an acquisition) rather than return excess funds to stockholders. And regardless of how diversified a corporation gets, the investment opportunities available within the firm are narrower than those available in the capital markets at large. Where the resource allocators within a diversified firm may have, at most, several dozen businesses they can fund, independent investors can have their pick from thousands of stocks.

Politicized decision making. Since corporate officers belong to the same organiza-

¹⁶ Bower (1972)

¹⁷ An A.T. Kearney study suggests that the corporate office costs of many diversified corporations are of the order of the firms' total profits.

tion as the unit managers, they may get better information than outside investors could from an independent company. On the other hand, membership of the same organization may lead to less objectivity and more politics in resource allocation and other decisions.

Misaligned Incentives. Problems of high overhead, bureaucratic decision making and the like, while commonly observed in diversified corporations, are not necessarily insurmountable. Consider for example, Berkshire Hathaway, a \$2.4 billion¹⁸ corporation whose businesses include insurance, newspapers, confectionery, discount furniture and children's encyclopedias. Corporate management consists of chairman Warren Buffet, Vice Chairman Charlie Munger and five other employees (including support staff). World Headquarters, in Kiewit Plaza, Omaha, occupies less than 1500 square feet.

Outstanding operating managers have come with acquisitions writes Buffet¹⁹, "and our main contribution has been not to get in their way. This approach seems elementary: if my job were to manage a golf team -- and if Jack Nicklaus or Arnold Palmer were willing to play for me -- neither would get a lot of directives from me about how to swing... Charlie and I could work with double the managers we now have, so long as they had the rare qualities of the present ones." The approach has been outstandingly successful -- as of 1986, Berkshire Hathaway had earned an average 23% return on equity for the 22 years Buffet had been in control.²⁰

A more fundamental problem with corporate offices lies in the difficulty of rewarding corporate officers for taking sensible decisions and punishing them if they don't. The average CEO of a diversified corporation usually does not have the incentives to manage like a Buffet. Rewards and punishments in the job are rarely an effective prod for superior performance.

¹⁸ Book value of shareholder equity in 1986.

¹⁹ Buffet (1987)

²⁰ Annual Report, 1986

Managers of diversified corporations cannot be easily disciplined if they deliver poor performance. Size protects incumbents: the CEO of a \$1 billion conglomerate is more firmly entrenched than the CEO of a \$100 million dollar business for two reasons. First, the raiders who might be attracted by the turn around opportunity that a poorly managed corporation represents will find it more difficult to raise \$1 billion of takeover financing than \$0.1 billion. Second, the larger corporation is likely to have more widely dispersed shareholders which raises the odds against a successful tender offer or proxy fight against incumbent management. And the weaker the threat of being displaced, the lower the incentives for managers to act in the best interest of shareholders.

The size of diversified firms is also an impediment to establishing appropriate financial incentives. Common sense, formal models²¹ and empirical research²² inform us that managers who own a lot of equity are more likely to think and behave like shareholders, while managers whose equity stake is low are more likely to maximize their own perquisites. High managerial ownership in a small single business firm is easily achieved. Quite commonly, managers are founders who retain a significant ownership stake, but if they are not, they can easily be allowed to "earn in" a reasonable share of the equity over a period of time. For example, as is common in professional partnerships, managers may be given a loan (to be repaid out of future income) to buy equity.

There are a few managers of diversified corporations who do own significant stakes. Warren Buffet and his wife for example own 45% of Berkshire Hathaway's stock. "We eat our own cooking", observes Buffet²³. "Although our form is corporate, our attitude is partnership. Charlie Munger and I think of our shareholders as owner-partners, and of ourselves as managing partners. In line with this owner-orientation, our directors

²¹ See Jensen and Meckling. (1976)

²² See, for example, Caves et al. (1987)

²³ Buffet (1987)

are all major shareholders of Berkshire Hathaway."

But Buffet is an exception - he built Berkshire Hathaway out of a small textile company shell and he didn't dilute away his stake by issuing stock to acquire companies - he paid cash. In 22 years since Buffet took control, corporate net worth increased 10,600% while shares outstanding increased less than 1%.²⁴ Berkshire Hathaway's extraordinary growth is due to Buffet's exceptional talent for buying undervalued stocks and companies.

More generally, high equity ownership by managers of a diversified corporation is rarely observed. Founding managers are less likely to be around: as Scott's²⁵ research suggests, diversification is undertaken at an advanced stage in a corporation's "life" after growth opportunities in the original businesses have been exhausted. And even if the founders are still managing the firm, chances are that the substantial amounts of stock that are usually issued to effect diversifying acquisitions will have diluted their equity stake to an insignificant proportion. Peter Grace of W.R. Grace for example owns less than 0.5% of the company's stock.²⁶

Nor is it easy to conceive of a mechanism by which a non-founding CEO of a diversified company may be allowed to "earn in" a significant share of equity. Consider two hypothetical firms - a \$100 million market value single business firm and a \$1 billion conglomerate consisting of ten \$100 million units - both of which have newly appointed CEOs. The small firm lends its new CEO \$5 million, which allows her to purchase 5% of its outstanding stock. The CEO is expected to pay back the \$5million loan at the rate of \$500,000 a year for 10 years, out of savings from an expected annual salary of \$1million. Suppose we wanted to set up a similar deal for the CEO of the diversified

²⁴ Annual Report, 1986.

²⁵ Scott (1970)

²⁶ As of 1986, Peter Grace owned 14,000 shares out of 42 million outstanding. Source: BusinessWeek, 10/23/87 p195, 4/17/87 p60).

firm. The CEO would have to be loaned \$50 million and (assuming similar tax and savings rates) be paid \$10 million a year.

But, on what grounds can we justify paying the CEO of the \$1 billion firm ten times the salary of the CEO of the \$100million firm? It is not at all clear that the CEO who allocates resources and monitors the performance of ten businesses "adds more value" than the CEO who has full operational and strategic responsibility for a single businesses. Indeed it may be argued that the former plays a more passive, distant role and is less likely to produce bottom line improvements than the latter.

Nor is there any evidence that higher salaries are justified by an extreme shortage in the skills required to be the CEO of a diversified corporation. Most diversified corporations have many experienced executives in their ranks - the problem in selecting a new CEO, Vancil's²⁷ research suggests, often lies in choosing among several equally qualified candidates.

Perhaps the only argument for paying the CEOs of diversified corporations a premium is that they are capable of doing more harm to shareholders. Just as it behooves the Wall Street Journal to pay an above market wage for the sensitive position of "Heard on the Street" columnist, it makes sense for a diversified corporation to pay its CEO more than what other equally qualified individuals who run single business firms earn. And indeed, we do see in practice that CEO compensation is correlated to firm size. But, it is important to note, the studies do not show a dollar for dollar correspondence - on average, the studies suggest, the CEO of the \$1 billion corporation is likely to earn three times as much as the CEO of a \$100 million firm, not the 10 times as would be required in the example above.²⁸

Unable to endow their top managers with significant equity stakes, diversified firms

27 Vancil (1987)

28 Murphy (1985)

often give them equity options instead. This is an imperfect substitute, as stock options can create incentive for managers to take decisions that are not in the best interests of their shareholders. First as Buffet²⁹ has pointed out, stock options create an incentive for managers to maximize stock price rather than total returns. Thus managers may choose to retain cash in the firm rather than pay out dividends, even when attractive investment opportunities are not available.³⁰

Second, options give managers an incentive to make risky investments. Consider for example, the CEO of a railroad whose stock is not expected to do much of anything in the next five years, when the CEO is expected to retire. It is early 1986 and oil prices have fallen to \$15/barrel. Suppose an investment banker suggests the acquisition of an oil company that will look terrific if oil prices rise above \$30 a barrel but not otherwise. While shareholders might balk, the CEO's stock options will give him a strong incentive to go through with the acquisition. If oil prices do rise, so will the value of his options; if they don't, the CEO has little to lose - at worst his options will expire without being exercised. In other words, incentives may get misaligned because, whereas shareholders can gain or lose real money, managers who own options enjoy only the upside of changes in the price of their stock.

The difficulty of setting the right incentives for the CEO of a diversified firm is similar to the problem of compensating a money manager with substantial funds under management. If a money manager has several billion dollars under management, a "performance" based fee may induce investments in the riskiest stocks - if the investments pay off, the manager makes a huge fortune, whereas if the value of the portfolio declines even by a small percentage, there is no way clients can make the

²⁹ Buffet (1987)

³⁰ Funds reinvested in marginal projects will normally increase a firm's stock price (and the value of stock options) more than funds returned to stockholders.

manager share in the losses. Managers of large funds are, therefore, usually given an annual fee equal to about 0.6% of assets, which is paid regardless of performance. While managers are not induced to take high risks, they do not have a great incentive to add much value either.³¹

In contrast, it is much more common to find small investment partnerships, where the managers are paid an incentive fee (similar to the earn-in arrangement previously described) that motivates them to maximize returns for shareholders.

2. THE INCREASING SOPHISTICATION OF CAPITAL MARKETS

In the previous section we established that diversification is more than a cosmetic organizational arrangement; bust-ups, we may thus infer, are likely to have significant economic consequences. And the question that we will address next is whether these consequences are likely to be positive or not.

The answer to this question could of course vary from firm to firm -- whether any particular organization can take advantage of the benefits of diversification while minimizing its liabilities will depend, to a certain extent upon the talents of the individuals who manage it and upon the history and culture of the institution. Our interest here however is in the general case -- we would like to examine why the diversified firm, which was so popular through the 'sixties, is under pressure today. Is it merely a shift in fashion, or has anything has changed that would undermine the advantages offered by the diversified firm in general?

Such a change, I will argue in this section, has in fact occurred -- the increased sophistication and efficiency of the external capital markets has undermined the usefulness of the internal markets of diversified firms. Wall Street, which was once a

³¹ Under this arrangement, clients at least can withdraw their funds if they are dissatisfied with an investment manager whereas investors in a diversified corporation are denied even this option.

cozy club, has been transformed. Business which used to be done on the basis of relationships, is much more competitive and requires strong analytical and market-making skills. And the development of these skills has greatly improved the external capital market's ability to monitor performance, allocate resources and help investors diversify away unsystematic risk.

2.1 The Evolution of External Markets

In the heyday of diversified corporations internal markets may well have possessed an edge, because the external markets were not highly developed. Business on Wall Street was based on relationships, not competence. But over the last decade or so, with the end of fixed stock commissions, other regulatory changes such as the institution of shelf registration and a bull market in financial assets, the basis of competition changed. Investment banks and other participants in the capital markets were forced to attract and deploy top quality analytical talent and build their market making capabilities. This substantially increased the external capital market's ability to monitor performance, allocate resources and allow investors to diversify their assets.

Two decades ago Wall Street was a sedate club. "When I first came to work" writes Baldwin, the former chairman of Morgan Stanley, "every senior person left their office a little before 12:00 and came back a little after 2:00, and they all went to the Bond Club luncheons. Everybody in Wall Street did the same thing. It was a different time schedule than you have today."³²

Competition was less than intense. "What you got paid for in Wall Street in those

³² Baldwin, Robert, Institutional Investor 6/87 p140

days" recounts another Morgan Stanley director, "was your origination. And your origination was a relationship business. It was unconscionable for someone to buy business."³³

The profession did not strive to attract the brightest and the best. It was, writes Levy: "the only aristocratic business in the U.S. By that I mean the only business where a father if he were a senior partner could count on passing the business on to his son." Fixed commissions and issuer loyalty meant that "you didn't have to be a genius to earn a living." Investment banking fathers could therefore "pass on a franchise that was protected by "The Club." All the qualities for inheritance were there."³⁴

Firms were small and thinly capitalized. In 1970, Morgan Stanley, then the premier institution of the industry, had 265 employees, \$7.5 million in capital, and no research department. The total capital of NYSE member firms was about \$4 billion.

Then came "Mayday" 1975 and the end of fixed commissions. Now institutional customers could negotiate the fees they paid for trading and individuals could use discount brokers. The average commission paid by institutions fell from 26 cents per share in April '75 to 7.5 cents per share in 1986. Where individuals paid 30 cents per share in commissions before Mayday, discount brokers were offering trades at 10 cents per share in 1986.³⁵

More competition was introduced in 1982 when the SEC adopted Rule 415 which allowed qualified companies to file a statement listing the amount of stock they expected to issue over the next two years. Whenever they believed market conditions were appropriate, these companies could quickly sell all or some portion of this stock to investors, without having to prepare a new prospectus. And just as Mayday put an end to

33 Fredrick Whitemore, Institutional Investor 6/87 p48

34 Levy, Leon, Institutional Investor 6/87 p291

35 Report of the Presidential Task Force on Market Mechanisms p11-15

fat trading commissions, Rule 415 jeopardized lucrative underwriting fees.

These changes according to one observer "dragged the whole industry into the twentieth century, kicking and screaming." Prices fell and several hundred securities firms went under. The basis of competition changed: firms couldn't rely on relationships to provide underwriting or commission income - the ability to market securities became critical.

Firms therefore had to develop professional research departments to analyze the prospects of the companies whose stocks they were trying to distribute. "During 1974 to 1976" writes Kaplan, "you began to see the emergence of the investment banking firms as voracious acquirers of analysts".³⁶ Standards too were raised: "There used to be analysts whose spreadsheets were on the back of envelopes. But the perception was they knew what they were talking about. No one wanted to see their numbers. They moved stocks. Now I think you see a more fully rounded job. You see a demand that the analyst conduct a pretty rigorous research."

Analysts specialized in order to cover fewer companies in greater depth. "Today you have one guy doing domestic oil, another doing international oil, a third doing exploration companies, a fourth guy doing oil service," writes veteran analyst Good who used to cover all these sectors *as well as* electronics companies.³⁷ In order to survive in the new environment, in other words, securities firms had to develop strong monitoring skills.

Attracting customers also required firms to develop their market making capabilities. The leading investment banks committed capital and personnel to build "block trading" desks which provided liquidity to clients who wanted to trade large blocks of

³⁶ Kaplan, Bennet, *Institutional Investor* 6/87 p183

³⁷ Good, Barry, *Institutional Investor* 6/87 p313-318

stock. The stock exchanges too instituted technological changes that could, by 1986 easily handle 200 million share trading days. Large and small investors alike thus gained access to the liquidity that would enable them to easily diversify away unsystematic risk on their own.

As with many other industries that have been deregulated, total demand and revenues rose as prices and margins fell. Increased competition, and one of the greatest bull markets in history, created a stronger and more prosperous securities industry that was able to pay for the new capabilities it had to develop.

Annual trading volume rose from 4.7b shares in 1975 to 35.7b in 1986 and commissions on stock trading earned rose from \$2.9 billion to \$13.4 billion. Total revenues for the securities industry rose from \$16b in 1980 to 50.1 billion in 1986 and total profits from \$2.3 b to \$5. b.³⁸ Total capital of NYSE member firms rose from 3.6 billion in '75 to 30.1 billion in 1986.³⁹ Morgan Stanley's capital rose from under \$10 million to \$786 million.⁴⁰

Increased revenues allowed securities firms to pay higher salaries for the research and trading staff they needed to attract. In 1978 for example there were only 41 analysts who made more than \$100,000; in 1987 there were about twenty who earned more than \$1 million and compensation of between \$250,000 to \$400,000 was commonplace.⁴¹ Total employment in the securities industry grew 9.5% per year from 1980 to 1986, compared to 1.9% in the rest of the economy. Incomes grew even faster 21.3% versus 7.3%.⁴²

With merit replacing birth as the qualification for entry and advancement, ambitious

38 Securities Industry Trends, various

39 NYSE Factbooks

40 Book value of equity, from Annual reports.

41 Institutional Investor 8/87 p131.

42 BusinessWeek, 10/26/87 p 31

young men and women who might have previously taken up positions in large diversified companies flocked to Wall Street. In 1986, one third of Yale's graduating class reportedly applied for jobs at a single securities firm. In the same year investment banks attracted thrice as many M.B.A.'s from Harvard as did industrial companies - a complete reversal of the ratios that prevailed in 1979.

This shift did not, as some critics have claimed, indicate that Wall Street was stealing talent from the real economy. Few of the '60s and '70s M.B.A.'s were wholly devoted to getting their hands dirty on the production line. More frequently, they filled positions in the internal capital market - preparing budgets and capital appropriation requests (in-house "prospectuses") or evaluating them ("buy side research"). Financial roles had been critical in their careers, no matter what their job titles. Now they were performing the same functions on Wall Street instead of within companies. The comparative advantage for attracting the talent necessary to monitor firm performance and allocate resources had shifted from the internal capital market to the external.

The blossoming of the external capital market was not confined to the public stock markets. Increased competition encouraged firms to seek opportunities in non-traditional fields. The venture capital industry, which could fund new businesses with speed and secrecy, was one beneficiary: Net new funds committed to venture capital rose from \$10 million in 1975 to \$4.5 billion in 1986.⁴³

Entrepreneurs could approach venture capitalists with some confidence that proprietary ideas would be protected and that the venture capitalists would not behave as bureaucratically as the resource allocators of diversified companies. The venture capital industry was young; firms in the business were small and free-wheeling. In 1986, the average \$ 30 million independent fund employed only 2 professionals. Whereas

⁴³ Venture Economics, Venture Capital Yearbook 1987 p 17

investments made by a diversified firm might require the "due diligence" of seven layers of management, venture capital funds could act expeditiously. And, unlike the functionaries of internal capital markets, they were prepared to bet on the visionary ideas of long-haired ex-TM instructors and cut deals which could potentially make the entrepreneurs whose projects they funded very rich. Thus the external capital markets could now claim an edge even in funding sensitive investments.

2.2 Rising Disclosure Requirements

Accompanying and reinforcing the financial industry's growing analytical abilities was a quiet but substantial improvement in the extent and reliability of information about companies' performance and prospects. Increasing disclosure requirements narrowed the information advantage that internal capital markets may have previously enjoyed.

Accounting standards, before and through the go-go 'sixties market, were, according to one observer, "whatever you wanted them to be." Companies, Wallace⁴⁴ writes, would "shop around for opinions," i.e. try to find pliant accounting firms that would endorse their creative book keeping. "Instant earnings " were created by "front ending" of revenue and "rear ending of expenses."

Accounting illusions were exposed in the bear market and the economic contraction of the early seventies, as several high fliers went bankrupt. The large, national CPA firms became defendants "in literally hundreds of class-action and other civil-damage suits, which took a heavy toll in the diversion of partner time, legal fees, and rapid escalation in premiums and deductibles for liability insurance."⁴⁵ Partners of big eight accounting firms were convicted of criminal fraud in the Commercial Vending and National Student Marketing cases.

⁴⁴ Wallace (1982)

⁴⁵ Wallace (1982)

In addition to shareholder suits, the accounting profession came under pressure from Congressional investigations. A Senate sub-committee produced a highly critical report called *The Accounting Establishment*. Legislation was introduced in the House proposing the establishment of a federal statutory organization to regulate accountants practicing before the SEC⁴⁶.

To protect itself against lawsuits and to head off demands for more federal regulation, the profession moved to improve and more stringently enforce accounting standards. Following the recommendations of the Wheat committee, the Financial Accounting Standards Board (FASB) was established in 1972. Concurrently, the American Institute of Certified Public Accounts (AICPA) adopted a rule which mandated that AICPA members comply with FASB standards. Self regulation was further tightened in 1977. Firms (rather than individuals) became subject to regulation, and they were required to have their system of quality control reviewed by a group of peers every three years. In addition firms that practiced before the SEC were subject to the oversight of a board composed of five prominent public members.

These changes greatly expanded the scope and reliability of the information available to the external capital markets. By the end of 1986 FASB had issued more than 80 opinions requiring public firms to disclose, among other things, line of business information, unfunded pension liabilities, foreign currency exposures and their replacement cost accounts. And since standards were now less flexible, outside analysts could place greater confidence in the data and more accurately compare the performance of different investment opportunities.

Increasing disclosure and the growth of the securities industry's analytical capability reinforced each other. As securities firms developed strong analytical skills, their

⁴⁶ i.e. Accountants who audited publicly held firms.

appetite for information grew and they began to set standards for disclosure that exceeded regulatory requirements. Conversely, higher regulatory standards provided more grist for the analytical mill and enabled brokerage firms to expand their monitoring capability.

3. INCREASING INVESTOR POWER

The greater sophistication of external capital markets not only undermined the economic utility of diversified firms, it also eroded managers' ability to maintain a form that did not provide economic value. A sub-industry developed to take advantage of opportunities to profit from breaking up diversified firms. It included analysts who analyzed "break-up" values of diversified firms, investment bankers and lawyers with the deal making skills needed to complete bust-up takeovers and junk-bond financiers who provided raiders with bridge financing.

Another important trend which undermined the diversified form was a resurgence of shareholder power. Absent strong shareholders, managers might have, as suited their independence goals, maintained diversified firms whose economic disadvantages outweighed their advantages.⁴⁷ The clout and sophistication of shareholders, which grew alongside that of the securities industry, however made preservation of the status quo difficult and facilitated raiders' efforts to break up companies.

At the height of the conglomerate boom in the sixties, control of the large American corporation seemed to have permanently passed into the hands of managers. This was quite a switch from the early days of the modern American enterprise, when financiers wielded great influence. Although they played no part in the day to day management, the financiers sat on the boards of companies, had veto power over major decisions and, when the occasion demanded, changed senior executives. For example, bankers were

⁴⁷ Mullins (1984) for example describes how proxy fights to break up closed ended funds -- moves that would immediately increase shareholder wealth -- used to fail by wide margins. Mullins ascribes the failure to a combination of apathy and the inability of shareholders to understand the issues.

instrumental in replacing Durant with Sloan at the helm of General Motors.⁴⁸

The key to the financiers' power was that wealth was highly concentrated - in 1919, the wealthiest 1 percent of the population earned 74 percent of all dividend income⁴⁹ - and ownership of companies, although separated from their management, was not fragmented. Individual financiers, acting for themselves or a few close associates, mattered. When Durant ran into financial difficulties at General Motors, he turned to the Du Pont family and J.P. Morgan, not the public at large.

Eventually though, the importance of the financiers declined. Ownership by a few large shareholders gave way to ownership by many small shareholders. Why this dispersion took place is not well understood - the reasons probably included the booming retail demand for stocks in the bull market of the 'twenties, redistributive taxes and the Malthusian dilution of family fortunes.⁵⁰ Another reason for the eclipse of the financiers, Chandler suggests, was that as the rapid growth of large corporations slowed down, they had less need for external capital and therefore did not have to accommodate investment bankers on their boards. "Financial" capitalism, as Chandler⁵¹ calls it, thus gave way to "managerial" capitalism.

Managers had great power under the new order. They were relatively free of the discipline of the market because the firms they managed faced a limited number of competitors, and they didn't have sharp eyed shareholders peering over their shoulders. Consequently managers had considerable discretion in pursuing their own goals including growth through diversifying acquisitions.

48 Chandler (1962)

49 Historical Statistics of the U.S. , Department of Commerce, p976

50 By 1948, the wealthiest 1 percent's share of dividend income had fallen to 53 percent from the 1919 level of 74 percent. Source: Historical Statistics, op cit.

51 Chandler (1977)

Managerial capitalism, it may be claimed in retrospect, peaked in the late 'sixties. When the New Industrial State was published in 1967, economists of Keynesian persuasion and managers of Fortune 500 companies were in charge, and all was right with the world. The economy was growing, almost without interruption: "In the two decades since World War II", noted Galbraith⁵², "serious recessions have been avoided." Large firms enjoyed reliable profits and thus independence from meddlesome stockholders. "The big corporations", wrote Galbraith, "do not lose money. In 1957, a year of mild recession in the U.S., not one of the one hundred largest U.S. corporations failed to turn a profit. Only one of the largest two hundred finished the year in the red."

Just when the technocracy of large corporations seemed invincible, the pendulum began to swing back in favor of stockholders. Managerial control was threatened by three trends that increased the power of the "suppliers" of capital.

First, financial self sufficiency of the large corporations was threatened. The economic climate turned less balmy. In 1970, the U.S. faced its first recession after nearly a decade. In 1973, oil prices tripled, precipitating a severe world wide recession in 1975. A relatively mild recession in 1980 was followed a business downturn in 1982 which, in some states, produced Depression level unemployment. In addition, U.S. firms began to face aggressive new entrants from overseas, most notably from Japan.

Large firms no longer enjoyed immunity from losses. Penn. Central filed for bankruptcy; Lockheed and Chrysler were spared this fate by a federal bailout. In the 1982 recession, eight of the top one hundred industrial companies and 21 of the largest two hundred ended the year with a deficit.⁵³ As profits declined and some firms suffered real losses, many companies lost their cherished financial self sufficiency and the need

⁵² Galbraith (1967)

⁵³ Fortune May 2, 1983, p228-247

for external funds became unavoidable. Corporate equity issues rose exponentially, from \$16.6b in 1980 to \$ 57b in 1986.⁵⁴ Managers could therefore no longer, so to speak, thumb their noses at investors.

Second, particularly after 1981, the federal government became an attractive alternative "customer" for capital. Large budget deficits forced the U.S. government to raise substantial funds from the capital markets, in competition with private corporations. With 14 percent annual yields and the full faith and credit of the Treasury, government bonds provided, "for the first time in our lives" in the words of one money manager, investors with a compelling alternative to stocks.

Third, and most importantly, stockholders became more concentrated. As managers advanced their own interests at the expense of their shareholders', they undermined the value of their company's stock. In only seven of the 40 years between 1945 and 1985 for example, did the stocks of the 500 largest U.S. companies trade above the replacement value of their assets. With greater competition, slower economic growth, and higher bond yields, stocks took a particularly fierce drubbing after 1973, losing *% of their real value in nine years. Even after the "historic" bull market since 1982, the Dow Jones average at the end of 1987 was a third below its real value of 1966.

Individual investors, therefore, withdrew from the stock market and put their money into housing or small entrepreneurial ventures where they could exercise more control over their investments. By 1986, stocks accounted for only 21%⁵⁵ of individuals' financial assets compared to 43%⁵⁶ in 1968. Individuals had been net sellers of stocks for every year since 1972. And as individual investors fled, the stockholders who remained

54 Securities Industry Trends, 3/30/87, p9

55 Federal Reserve, Flow of Funds.

56 Historical Statistics, op cit.

were a relatively small number of large institutions who were potentially a more equal match for management.

Institutional ownership of stocks, which grew from 30.9%⁵⁷ to 39%⁵⁸ between 1970 and 1986, was especially pronounced in the large firms. Institutions were attracted to large companies because they could invest substantial sums in such stocks and individuals were ready sellers as they had learned to shun companies where management did not hold a significant ownership stake. Consequently, in 1986, institutional ownership of the top 100 industrial firms was about 53% and of the next 100 firms, 50%. Institutions accounted for a majority of the ownership in nearly two thirds of the top 200 companies.⁵⁹

The increase in shareholder power has facilitated raiders' efforts to break up diversified companies that might have been held together for purely managerial reasons. For example, investors are more likely to sell their shares to a raider when they have attractive investment alternatives, such as government bonds with high real yields or stock reluctantly issued at depressed prices. Similarly, raiders stand a better chance of winning the support of a small number of professional, institutional investors who have the resources to analyze and respond to proxy solicitations rather than of many dispersed individuals.

4. SUMMARY

On average, I have argued in this chapter, the unraveling of diversified companies probably makes economic sense. External capital markets have come of age, in terms of the analytical skills they can attract and deploy, while there is no evidence of a

⁵⁷ Statistical Bulletin, SEC, 5/75 p 439

⁵⁸ Barrons, Spectrum report, 3/9/87 p44

⁵⁹ Computed from institutional ownership tables in BusinessWeek, 4/17/87 p46-57.

corresponding improvement in the functioning of corporate hierarchies. The diversified firm is therefore a less valuable institution than it might once have been. And as a practical matter, since investors are more concentrated and enjoy broader investment opportunities, they are less tolerant of an organizational form maintained for managerial reasons.

This is not to claim that all diversified firms don't add value or that every bust-up is guaranteed to be a financial success in the long term. We cannot rule out the possibility that some buyers may begin paying (if they haven't done so already) absurd prices for divested units, following the new conventional wisdom that free standing businesses are infinitely more valuable than a conglomerate. Nor are all external capital markets the epitome of rationality and foresight -- indeed in the next chapter I will argue that external public markets (i.e. stock markets) have serious deficiencies as compared to the external markets for private capital.

But it is reasonable to claim that even if some bust-ups are a fad, in general they have an economic basis. And although some sectors of the external capital markets have flaws, they probably do have an edge today, in their ability to monitor performance and allocate resources, over the internal markets of diversified companies.

Chapter 5: In private hands

When raiders break up diversified corporations, we saw in Chapter 3, they often sell units to private firms or partnerships. These transfers of control from "public" to "private" ownership could be pure accident; indicative of the excessive optimism of private bidders; or, it could reflect the value added by the transfer.

I will argue in this chapter that the transfer to private ownership is not mere happenstance -- private firms and groups often come out ahead in the bidding for the businesses that raiders put on the block because they add real value and because the environment is more conducive to private ownership. In order, I will try to support the following propositions:

1. Private ownership of firms has significant economic consequences -- it matters whether a business is publicly or privately owned.
2. Public ownership is less desirable than private ownership for small organizations that do not frequently need to raise capital. Transferring the mature fragments of large conglomerates to private ownership may therefore create economic value.
3. Raiders are more likely to find private groups offering the highest prices for the units they wish to sell because of the growth of a "private" capital market -- since the early 'eighties we have seen the evolution of promoters with the know-how to take public companies private and of investors who are prepared to fund the promoters.

1. HOW THE FORM OF OWNERSHIP MATTERS

1.1 The Key Difference -- Speculation

According to Fama and Jensen, the essential difference between public and private (or what they call "open" and "closed" firms) turns on who is allowed to own stock. In the closed firm, as Fama and Jensen define it, ownership is restricted to internal decision agents whereas in the open firm, any member of the public can be an owner. Consequently, public firms can achieve specialization of risk bearing and management, while in a private firm, "the decision process suffers efficiency losses because decision agents must be chosen on the basis of wealth and willingness to bear risk as well as for decision skills."¹ On the other hand, private firms which are owned by decision agents are better protected from opportunistic behavior by these agents.

Now while many private businesses such as law and accounting firms do restrict ownership to active partners, this does not appear to be a general rule for "private" organizations. For example, oil and gas and real estate partnerships are financed by passive "retail" investors and stock in many large private industrial firms is owned by distant heirs of the founding "decision agent." And, most importantly, for our discussion, many of the equity investors in the private organizations formed to buy units divested by raiders, are large pension funds who are invited into deals because of their capital rather than their "decision skills". Therefore the trade-offs described by Fama and Jensen² are not immediately germane to our discussion.

The more general distinction between public and private turns upon the ease of alienability of ownership. Stock in a public company is freely alienable, not only because there are no restrictions on ownership, but also because the firm complies with S.E.C.

¹ Fama and Jensen (1983)

² Fama and Jensen (1983)

regulations governing publicly traded companies, pays the listing fees and meets the other implicit and explicit requirements for the trading of its stock on an exchange. Stock in a private company is usually less freely alienable, even if the articles of incorporation do not restrict the transfer of ownership, because the firm chooses not to take the steps that would allow its stock to be freely traded.³

Free alienability of a stock becomes important to the extent it attracts the attention of short term traders or "speculators". Speculators are not interested in buying a share of a business for the long haul. Rather, they buy a stock when their fundamental analyses, charts, brokers, intuition or inside tipster tells them that they will soon be able to sell it at a higher price. Conversely, speculators sell a stock when they expect its price is more likely to go down than up. By frequently buying and selling stocks, speculators hope to make "excess returns", i.e., realize higher profits than investors who buy and hold stocks for the long term.

Since ownership cannot be easily transferred, there is by definition no short term speculation in the shares of private companies. Stock is exclusively owned by buy and hold investors who believe in the long term value of the business.

On the face of it, we shouldn't expect speculative activity to be very high even in public companies. Speculators engage in a battle of wits with each other for excess returns in which there have to be as many losers as winners. Simple arithmetic shows that speculators who get in and out of a stock cannot collectively earn higher returns than investors who buy and hold -- above average profits of the successful speculators are made at the expense of those speculators who make below average profits. In fact, since in-and-out trading is accompanied by transaction costs such as brokerage fees, the

³ Furthermore, the distinction may be one of degree rather than category. The stock even of a publicly traded firm like Teledyne or Berkshire Hathaway may not be easily alienable if the managers choose to discourage liquidity by for example, not talking to analysts or not splitting the stock when its price gets too high.

bid-asked paid to market makers, and taxes,⁴ total excess returns to speculative activity must actually be negative.⁵

Therefore over time, we might be led to believe, speculative activity should become, at best, sporadic. The unsuccessful speculators should drop out of the game, leaving the good speculators (if any) to trade with the occasional long term investor who wishes to enter or leave the stock market, or with firms raising new capital. We should therefore expect that the free alienability of public company stocks will not be extensively taken advantage of and that there will in fact be no major difference between private and public firms.

And indeed there are a few public firms whose stocks are shunned by speculators, and it wouldn't make much practical difference if these firms were private. But in general, we observe that short term trading is quite frenetic and most indications are that speculative transactions appear to swamp those undertaken for fundamental economic reasons. In 1986 for example \$1.8 trillion of stock was traded on U.S. exchanges, compared to an outstanding equity base of about \$2.8 trillion.⁶ Traders exchanging pieces of paper with each other appear to have been far more active than firms raising new funds or investors adding to or subtracting from their stock of equities: compared to the total trading volume of \$1.8 trillion, corporations issued only \$57 billion of new equity, households withdrew \$118 billion from the equity market, institutional investors added \$20 billion to their portfolios and foreign investors bought about \$43 billion of U.S. equities.⁷

4 Note that the tax code for trading profits is asymmetric. The winners pay taxes on their entire gain; the losers can deduct only \$3000 per calendar year.

5 As Ellis (1985) puts it: "[Institutional investors] cannot, as a group, outperform themselves. In fact, given the cost of active management -- fees, commissions, and so forth -- most large institutional investors will, over the long term, underperform the overall market. Because investing institutions are so numerous and capable and determined to do well for their clients, investment management is not a winner's game. It is a loser's game."

6 Presidential Report, op cit.

7 Federal Reserve, Flow of Funds; Spectrum report in Barron's 3/9/86 p44.

Institutional investors appear to be particularly energetic at swapping portfolios. Lowenstein estimates that the average institution turns over its entire portfolio every year.⁸

There are several possible explanations why speculative trading is so widespread: Speculation may be rewarding in and of itself. Schelling has described the stock market as the "greatest gambling enterprise in the U.S.". The thrill of gambling may compensate speculators for their poor financial returns.

Keynes, who was no mean speculator himself, compared professional trading to "... a game of Snap, of Old Maid or musical chairs - a pastime in which he is victor who says *Snap* neither too soon nor too late, who passes the Old Maid to his neighbour before the game is over, who secures a chair for himself when the music stops. These games can be played with zest and enjoyment, though all the players know that it is the Old Maid which is circulating, or that when the music stops some of the players may find themselves unseated."⁹

Ignorance may also play a role. Speculation in stocks, unlike in casinos, produces a net positive return for the average player, because stock prices generally go up over time. Speculators therefore suffer only opportunity losses -- their returns are lower than a buy-and-hold investor's. If they can't (or choose not to) track these opportunity losses, speculators may never realize that in-and-out trading is a losing proposition.

Third, the speculators who get wiped out or otherwise realize that excess returns are not easily earned may be replaced by a new generation of speculators.

Finally, professional money managers may be as much in the business of entertaining their clients and providing them with vicarious speculative thrills as of maximizing financial returns. Active managers don't just manage money -- they provide

⁸ Quoted in the New York Times 2/17/88 pD2

⁹ Keynes (1936)

clients with engaging accounts of clever trading schemes, post-hoc analyses of why the market did what it did, hot stock tips (which clients can impress friends and acquaintances with) and ingenious rationalizations for their failure to beat the market. And rewards for providing this entertainment are handsome -- active managers command about six times the fees of indexers who merely buy and hold the market portfolio.

1.2 Benefits Speculators Provide to Public Firms

Although speculative trading is often considered anti-social, it can provide positive externalities. Speculators may lower the cost of equity for public firms by providing investors with liquidity, low transaction costs, and easy access to intermediaries. And the public firm's advantages in raising equity may also give it an edge in raising debt.

1. Liquidity.

Speculative trading may reduce a public firm's cost of capital by providing investors with the assurance that if they should develop an unexpected need for funds they will be able to cash out their holdings quickly. Absent speculators, investors in public stocks might not enjoy much higher liquidity than investors in private companies -- free alienability would be of little value if there were no buyers to be found. Active speculators who are constantly trading stock ensure that investors who might need to sell their stock will find many buyers ready to take it off their hands.

2. Transaction costs.

Speculators also reduce two significant (and often overlooked) expenses of getting into and out of investments -- analytic costs and negotiation costs.

Competition among speculators, according to the efficient market hypothesis, leads to stock prices that, at all times, fully and fairly reflect all available information. The claim is probably exaggerated. It is difficult to believe that the collective opinion of

speculators, palpably engaged in a money losing enterprise, always reflects the true value of every firm's stock.

More plausibly though, we could say that, in the long run, stock prices do not deviate too far from their underlying economic values -- speculative frenzies in either direction do not run on for ever. And in the short run, deviations are random or "unbiased" -- speculators may be flighty from minute to minute, but it is hard to predict which direction they will jump next.

The implication for the average long term investor is that there is no particular reward for efforts expended to determine a stock's fair value or the most opportune moment for its purchase. Indeed, on average, selecting stocks by throwing darts may produce the same long term results as a laborious analysis. Speculators thus provide a great boon to the investors who lack the means to analyze stocks and to the public firms who wish to raise funds from them.

Investors in private companies in contrast, do not have the crutch of the market price to lean upon. Prudence requires them to expend resources to analyze individual deals in some detail, and investors who do not possess these resources may have to forgo the purchase of private company stock altogether.

Speculators also eliminate investors' negotiation costs. Buyers and sellers of "private" assets may have to go through protracted bargaining before they agree to trade because there is no market price they can rely on -- buyers know they shouldn't take the first offer and sellers accept the first bid. Both sides may expend time and other resources trying to determine the other's reservation price and in arguing the merits of their case. If the parties are sufficiently obstinate, the transaction may not be completed at all.

In contrast, there is no haggling when investors in a public firm wish to sell their

stock. There is a constant stream of buyers and sellers, as well as market makers who stand ready to buy or sell at prices very close to each other: you either sell stock at the best bid in the market or not at all.¹⁰

The near elimination of analytical and negotiation costs can lower a public firm's cost of equity for three reasons.

First, investors in public firms know, *ex-ante*, that lower transaction costs will be incurred when the time comes to sell their holdings; hence, they may be willing to accept lower expected "gross" returns when they make their investments than investors in private companies.

Second, low transaction costs help investors reduce unsystematic risk - the most oft-cited advantage of public stock markets. Investors can buy forty publicly traded stocks as easily as they can buy four and thus diversify away their unsystematic risk. Private firms, whose investors incur costs in analyzing and negotiating the terms of each of their investments and cannot so easily diversify away unsystematic risk, may therefore face higher capital costs.

Third, the issuing of stock itself constitutes a transaction between existing and new owners which may be more efficiently completed in a public company. When a private firm issues equity, buyers have to expend analytical resources to make sure they aren't being sold a lemon (the information asymmetry problem), and to negotiate, sometimes at great length, the share of ownership existing stockholders will give up for the funds raised.

In contrast, public companies (and their underwriters) have a market benchmark that establishes a fair price for new capital. Although there may be some negotiation

¹⁰ See Warren Buffet's description of a "Mr. Market" in Berkshire Hathaway's 1987 Annual Report.

between issuers and their investment banks over underwriting terms and conditions, at the end of the day, a firm either issues stock at about the market price, or it does not. Speculators take most of the argument away.

3. Access to intermediaries

Actively traded public stock markets reduce the agency costs of using investment intermediaries. Investors who lack the resources or self confidence to buy securities on their own, can turn to money managers or mutual funds; monitoring such intermediaries is relatively easy when the investments they make are in actively traded securities which have reliable, published prices. For example, an investor can buy into or get out of a mutual fund at a price which reflects the true market value of the stocks in the fund. Monitoring the ongoing performance of the fund is likewise straightforward.

Investors who entrust their funds to intermediaries to buy into illiquid assets (such as shares in a private company) face considerably higher risks. Promoters may inflate the value of the assets they are acquiring, and deceive investors about their ongoing performance by paying out returns which are really a liquidation of capital.

4. Cheaper debt

Finally, the public firm may be at an advantage in raising debt. A firm's access to public capital markets, where it can issue new equity easily and quickly, reduces the riskiness of its debt. For if a public firm has difficulty in meeting its interest payments, it at least has the option of raising new equity to retire some of its debt obligations. A firm whose stock is publicly traded may also have better access to public debt markets because bond investors can take advantage the research done by stock analysts and the

information that public companies have to disclose in the regular course. Lenders to a private company have to make a much greater investment in credit analysis, which may be reflected in higher costs for the borrower.

1.3 Disadvantages of the Public form.

Liquidity of investment, unbiased prices and low negotiation costs are not a free lunch. The public markets can extract their pound of flesh by consuming resources, inducing volatility, tempting shareholders to shirk their responsibilities and disrupting shareholder-manager relationships.

1. Resources Consumed.

Most obviously, resources have to be expended by the public corporation to satisfy the S.E.C.'s disclosure requirements. Even more challenging is the task of feeding the market's appetite for information. Senior managers may have to make presentations to securities analysts and field endless impromptu queries about earnings projections, even after their firms have incurred the expense of establishing an investor relations department. And in providing this information, managers must worry about giving away too much data to competitors and about class action suits that might be filed by shareholders.

Of course private companies have to keep their investors informed about business developments too, but the process is cheaper and more efficient. The private company has to provide information to a relatively small number of actual owners, not to the large population of window shoppers and tire kickers who populate the public markets. Reports can be tailored to the needs of the investor group rather than to the lowest common denominator of the securities analyst community. And the information provided can be more complete and honest; managers do not have to be as concerned about

protecting sensitive data or being sued.

The activity of speculative trading itself also requires a slew of resources including the services of portfolio managers, salesmen, securities analysts, floor brokers, market makers and back office personnel as well as the incremental capital required to support trading. Even a partial measure of the resources consumed -- commission costs -- reveal their considerable magnitude. In 1986 stock trading commissions amounted to \$13.4 billion¹¹, which represents about 8.5% of the total earnings¹² of all public companies in the U.S. in that year. A broader estimate suggests that trading by institutional investors consumed resources equal to about a sixth of the total earnings of the companies they owned.¹³

2. Disruptive Volatility

It could be argued that speculative trading takes place between consenting adults. Their willingness to dissipate their wealth on bid asked spreads and trading commissions deserves no more censure than expenditures on junk food or movie tickets. The long term investor doesn't have to be drawn into the game -- liquidity is merely an option provided by speculators which doesn't necessarily have to be availed of. And there is no reason at all for firms to be affected by the velocity with which their paper is passed around.

But in fact, as I will argue in the concluding chapter, the institutional investors who account for nearly half the trading on the New York Stock Exchange are not consenting adults, free to indulge their gambling instincts. They are fiduciaries, who invest funds on someone else's behalf; to the extent that they are sucked into churning their portfolios,

¹¹ Securities Industry Trends.

¹² Earnings calculated by dividing the market value of outstanding stock by the "market" price earnings ratio. Source: Presidential Report.

¹³ Lowenstein, op cit.

they may undermine their sponsors' willingness to commit funds to the stock market. Secondly, even buy-and-hold investors and the firms who don't bear transaction costs may be hurt by the high volatility demanded by speculators as their price for providing liquidity.

Speculators seek opportunities to place bets with big payoffs. Stable or predictable prices are by definition uninteresting. Speculators will flock to futures markets where the expected total returns for the average player -- not just the excess returns over opportunity cost -- are known to be zero because there is some chance of an enormous profit; the 7% guaranteed return savings bond will however be left severely alone. A liquid stock market therefore requires price volatility. J. P. Morgan's famous, "The market will fluctuate" is more than a prediction - it is a precondition for the market's functioning.

Now what could cause stock prices to fluctuate? Market prices in general can bounce around because of fundamental external factors: for example, an unexpected freeze in Florida or a surprise cut in the Fed's discount rate will cause the prices of orange juice or Treasury bond futures to soar. Prices can also be moved because of shifts in internal market sentiment, e.g. because some speculators believe other speculators are on the verge of becoming much more bullish.

Stock prices are particularly apt to be moved by the second set of factors. The true value of a stock, at least in theory, is based on profits that are expected to be earned in the distant future -- and in fact, current year earnings rarely exceed 15% of a stock's price. Long term profitability, depending upon which theory you subscribe to, depends upon external industry factors such as the intensity of competition, the threat of substitutes and supplier power, or upon internal organizational factors such as the firm's values and ability to foster innovation. It is difficult to imagine that any of these determinants of a

firm's long term profitability change very much in the short term; events that dramatically change the long term value of a firm overnight such as the discovery of a miracle drug or a major oil strike are extremely rare. Therefore, if speculators had to rely on significant new information to move prices, they would soon lose patience with stock trading.

Changes in sentiment (or if you will, in market expectations) of a stock's discounted cash flows can however provide the volatility that speculators seek. Players can seize upon trivial or even totally irrelevant information (such as whether an A.F.C. team wins the Super Bowl) to keep prices in a constant state of agitation. Price action in a stock market can therefore be as thrilling, random and meaningful as the spin of a roulette wheel.

Investors can of course, be advised to ignore the noise generated by speculation, since the underlying trend of stock prices is usually up, and in the long term prices rise in line with underlying economic values. It may also be true that if investors tried to ascertain the value of their untraded assets every day, they might observe unreasonably fluctuating prices too. But the reality is that most investors don't mark their unlisted assets to market every day and few can resist frequent monitoring of the market price of their stocks. Therefore, just as the potential for liquidity is a psychological plus even for the long term investor who has no reason to take advantage of it, so also is short term volatility a psychological minus.

Another drawback of stock volatility, according to Keynes¹⁴, is that it confuses the firm's investment decisions. Encouraged by a high stock price, a firm may undertake a new project today, only to scrub it tomorrow if the stock price falls. Whatever the theoretical merits of the argument¹⁵, there is no empirical evidence whatsoever that firms

¹⁴ Keynes (1936)

¹⁵ Which has been criticized by the rational expectations school.

actually pay attention to stock price movements when they make their investment decisions. Investment decisions in the real world, Bower's¹⁶ research suggests, are made over an extended period, and once undertaken, projects cannot be easily scrapped. In fact it is difficult to imagine how an investment policy that took its cue from stock prices could be reliably implemented. Therefore we need not worry about volatility on this score.

A more realistic case could be made however that excessive volatility can hurt the morale of managers and other employees. Falling stock prices may, albeit irrationally, evoke fears of takeovers and discourage employees from making firm specific investments.¹⁷ Sharp gains may dampen the motivation of managers who had the good fortune to be granted options at low prices while making it difficult for the firm to attract new employees with similar incentives. And to the extent that employees regard the firm's stock price as an unbiased composite indicator of their performance, they may distracted by its zigs and zags.

3. Shirking responsibilities

Perhaps the most significant drawback of a liquid stock market is that it tempts investors to shirk their responsibilities, most notably, of monitoring and disciplining managers. To a certain extent, disciplining managers always poses a free rider problem when a business has more than one owner. As Mullins¹⁸ points out: "the gain produced by discipline is shared proportionally by all shareholders while the costs.. are usually borne only by those who initiate discipline. This asymetry, benefits accruing to all and costs borne by a few, discourages discipline."

Free riding is less of a problem in a private firm because ownership is usually more

¹⁶ Bower (1970)

¹⁷ DeAngelo and DeAngelo (1987).

¹⁸ Mullins (1984)

concentrated. The higher costs of diversification means that investors will buy into larger blocks of fewer companies. And any one of five twenty-percent owners is more likely to expend resources for the benefit of the group than any one of a thousand 0.1 percent owners. In addition, the social pressure to cooperate within a small group of five owners is likely to be greater than within an anonymous crowd of one thousand.

The temptation to avoid the bother of disciplining managers is also greater in public companies where a liquid market allows owners to opt out of a difficult situation. In contrast, if transferability of ownership is restricted, and the owners know that they are stuck with a firm for the long haul, they will have stronger incentives to fix or prevent problems of managerial behavior.

The easy diversification provided by public markets in other words creates an Arrowian insurance problem. Investors diversify (or pool their holdings) in order to insure themselves against unsystematic risk; the insurance scheme may however induce participants to behave in a fashion that increases a particular kind of unsystematic risk -- namely that managers will act opportunistically because they are not closely monitored. And the greater the risk that managers will behave opportunistically, the greater is the incentive for investors to increase diversification.

4. Discordant relationships

In traditional models¹⁹, conflicts between principals and agents arise only out of divergent interests -- managers seek to maximize their personal wealth and perquisites while shareholders seek to maximize the value of the firm. In the real world, conflicts between owners and managers may also arise out of misunderstanding and poor communication -- the sales conference in Hawaii which is seen as an invaluable investment in employee morale by managers may be regarded as a frivolous waste of

¹⁹ e.g. Jensen and Meckling (1976)

corporate funds by stockholders. And such misunderstandings may cause managers, if they have the power, to sabotage the economic interests of the shareholders and shareholders to keep managers on an uncomfortably short leash.

Public firms are especially prone to poor communication between owners and managers. A common complaint by managers of public companies is that shareholders are absentee landlords who have no loyalty to the firm whose shares they own. Speculators are interested in owning a stock only from the time it is undervalued to the moment it is (by whatever calculus they might employ) fully valued. Long term investors who buy and hold an index are not held in much higher esteem by managers either. Between a third or a half of Champion International's shareholders, claimed Sigler, the company's chairman in Congressional testimony, "bought the stock without any human knowledge and, because of the way the system works, really don't care whether that stock goes up or down, as long as it tracks [an] index... I have very few long term shareholders who are interested in the company.."²⁰

There is very likely an element of posturing in Sigler's complaints. There is no reason why managers shouldn't be delighted if their firm's stocks are owned by index funds who are not interested in the performance of individual companies and who will therefore not breathe down the managers' necks. And if managers of private companies voice fewer complaints about the quality of their owners, it may well be because they dare not!

Nevertheless, to the extent that owner-manager compatibility is good for the enterprise, it is more likely to be found in private companies. First, ownership is less fragmented, and a personal relationship between owners and managers is at least feasible. Second, owners are, perforce, more loyal and therefore more likely to develop long term

²⁰ Hearings, p146.

relationships with managers through which they gain a deeper understanding of the affairs of the firm and the concerns of the employees while at the same time impressing their goals on managers.

Third, since owners and managers of a private firm know they are going to have to deal with each other for a long time, compatibility of temperament and values can be an important consideration at the time the firm is put together. Personal chemistry may well override purely financial considerations as managers will seek out investors who they feel comfortable with and vice versa.

Public firms have little choice in the composition of their ownership. When they first go public, firms may choose which underwriter they wish to use but not which investors the underwriter sells the stock to. And once public, firms may try to influence the composition of their ownership but cannot easily prevent undesirable individuals from owning their stock.

2. FIT BETWEEN PRIVATE OWNERSHIP AND DIVESTED BUSINESSES

Both types of ownership, we have seen, have their pluses and minuses. The issue of interest to us here is whether private ownership best suits the types of firms that are spun off by the raiders. Let us therefore turn our attention to two characteristics that might cause a business to be more suited for public or private ownership -- its size and its need for new capital.

2.1 Size of the Business

Public ownership better suits large businesses. Other things being equal, larger organizations require more capital and therefore more stockholders. And a large ownership group may be better served by a public form of incorporation for two reasons:

First, the larger the number of stockholders, the greater is the possibility that at any

time some shareholders may have a real (i.e. non-speculative) motive for liquidating their investments. A \$90 billion dollar corporation like I.B.M.²¹ is likely to have, on any given day, several hundred, if not thousand shareholders who wish to sell shares to raise funds to make a down payment on a house, the kids' tuition or even estate taxes on inherited stock. Hence a liquid public market where these thousands of investors can sell their shares is much more important for a corporation like AT&T than it is for a small accounting firm where years may go by before any of the partners wants to sell out.

Second, a private firm requires a congenial, like-minded stockholder group which is difficult to assemble if the number of owners is very large. As previously mentioned, since shareholders of a private company expend considerable analytical resources before investing and face obstacles to getting out, they have a strong incentive to monitor the performance of a business closely and occasionally to try to influence its policies. In real firms, as opposed to the realm of equilibrium models, such intervention may not always be constructive.

In life if not in theory, human beings possessed of the same information and trying to achieve similar ends may nevertheless disagree about the means. One stockholder in a software firm may favor pursuit of the educational market, while another might believe that the networking market has greater potential. And since owners are not organized in a hierarchy, wrangling between them may confuse managers and lead to delayed or inconsistent decisions. Therefore in a private firm, where shareholders have a strong incentive to be active in firm governance, it is important that the owners have compatible temperaments and are in agreement about the overall strategy of the firm. Otherwise, meddling by the owners may tear the business apart.

The greater the number of stockholders, the less likely it is that they will form a

²¹ Market value as of 3/20/87 as reported in *BusinessWeek*, 4/17/87, p46.

cohesive group. Hence, for a large firm like I.B.M., ownership by more passive public stockholders who give managers the leeway to make decisions about dividend policy, pricing, and whether or not to invest in fundamental research may be more constructive²².

The advantages of a public firm in raising debt may also be magnified by size. A small firm can establish a relationship with one lender who over time gets to understand its business and financial risks. A large firm must borrow from several sources and often the cheapest debt is available in the public bond markets. And investors in bond markets, as has been previously mentioned, are more likely to be receptive to the debt offerings of a well scrutinized public company than those of a private company.

2.2 Need for New Capital

The other important characteristic which affects the public-private trade-off is the firm's need for new capital. Public ownership is favored if the firm needs to frequently raise large amounts of capital to finance its growth. Private ownership is more suited for mature businesses which generate more cash than they can profitably invest.

For most firms, the need for substantial new capital is most acute in their so-called growth phase.²³ By this stage the early uncertainties about technology and consumer acceptance have been resolved, the orders are pouring in, and the firm needs money for new production capacity, working capital and marketing programs. As no great secrets have to be concealed and the firm cannot afford extended negotiations for raising new funds, the public form of ownership is best suited to this phase.

As a business matures, its needs for additional capital decline and eventually it can generate excess cash. The public corporations' ability to raise funds without incurring high negotiation costs becomes less salient. At the same time, owners need to exercise

²² We might of course argue that a firm shouldn't be so large that it cannot be owned by a cohesive group of owners. Here I am assuming that there are compelling technological or transactions cost reasons that override this consideration.

²³ See Kotler (1972) for a description of industry life cycles.

closer control, since managers now have the excess cash flow to dissipate on marginal investments. And this control, we have previously seen, is best exercised by a small close-knit group of private company owners rather than by a crowd of public shareholders.²⁴

Private ownership for the businesses created by splitting up diversified firms is favored on both size and maturity counts. Although the data available on prices paid is spotty, we do know that businesses divested were obviously smaller than their parent corporations, and that the parent corporations themselves were of moderate size -- none of the hostile 1985 targets for example made the top 100 list of U.S. corporations.²⁵ From the divestitures for which we have data, we see that the highest sales price was \$1600 million, and the median sales price was \$225 million, and the average \$365 million. By way of comparison, the 500 th. largest public firm in the U.S. in 1985²⁶ had assets of \$2.1 billion.

And as we saw in Chapter 3, the targets of hostile takeovers were low- growth, low-tech companies with significant free cash-flows and virtually no R&D spending. The divested units were correspondingly in mature businesses -- paper distribution, commodity chemicals, bowling alleys and metal bending. These businesses needed ownership structures that could best prevent the waste of surplus cash, not ones that were optimal for raising new funds.

²⁴ Private ownership, we may note in passing, is also favored in the very early stages of a businesses life cycle when the firm needs to raise small amounts of seed money but cannot afford, for cost or confidentiality reasons, to disclose the information that public markets require.

²⁵ Ranked by market value, BusinessWeek '85 survey.

²⁶ Ranked by assets (Source: Forbes 4/28/86 p140). Ideally we would have preferred a ranking by total firm value (debt + equity) in order to make the right comparison.

3. FACTORS FACILITATING PRIVATE OWNERSHIP

The mere economic desirability of private ownership for the units being divested might not have led to real bids from private groups had it not been for three other developments that were taking place alongside the hostile takeover movement. First was the increasing number of promoters who were capable of putting together deals to take businesses private. Second was the greater willingness of institutional investors to back promoters with equity financing. And third was the growing availability of debt. Let us consider these factors in turn.

3.1 Buyout Promoters

The business of taking firms private is new. The first significant buyout -- of Houdaille Industries, a Florida automotive parts dealer -- was completed in 1979, five years after the first major hostile tender offer.

The business was initially dominated by a handful of boutiques like Kohlberg, Kravis and Roberts (KKR), Forstmann-Little, Wesray and Thomas H. Lee. These boutiques reputedly earned extraordinary returns -- William Simon's Wesray Corporation, for example, made 250 times its investment from its purchase of Gibson Greetings. A buyout fund launched by Forstmann-Little in 1983 was said to have made a 95.2% annualized return on equity invested as of the end of 1986. The same firm is said to have turned \$180 million of its own equity in 1978 to \$1.5 billion in 1986. KKR, the first and still largest of the boutiques is estimated to have earned about a 45% annual rate of return since its inception in 1976.²⁷

The success of the boutiques did not go unnoticed on Wall Street. First Boston was the first investment bank to do a significant buyout with its own investment funds when it

²⁷ Returns reported in *Institutional Investor* 11/86 pp69-78

acquired Congoleum Corp. Thereafter, Merrill Lynch was a promoter of and investor in several large deals including the acquisitions of Fruehauf, Jack Eckerd and Signode Corp. Shearson Lehman organized the purchase of Sheller-Globe Corp. and Formica Corp. And E.F. Hutton put together a mutual fund to invest in buyouts. By 1986, virtually every major investment bank had entered the business of taking firms private usually by attempting to leverage both their deal-making skills and their capital.

Other entrants in the business included the venture capital arms of money-center banks like Citicorp and Bankers Trust, investment vehicles of wealthy families like the Bass Brothers and the Pritzkers, and money managers like Gabelli. Therefore, by 1984-1985, when raiders began actively seeking buyers for the units which they wished to sell, there were many private promoters who had the interest and the know-how to put together a bid.

3.2 Support of Institutional Investors

Left to their own financial resources however, the boutiques and other buyout promoters might not have been able to buy very many businesses. Fortunately for the boutiques, their early successes attracted more than just new competitors -- the large pension funds, drawn by returns that far exceeded the returns in the public stock markets, began to commit serious funds to buyout deals. And with the equity provided by institutional investors, the promoters became a potent force in the private capital markets.

Large pension funds were, and are, natural investors in buyout deals. The disadvantages of private companies -- illiquidity, high entry cost and the difficulty of using intermediaries -- matter less to a large pension fund than to a small individual.

First, a substantial portion of funds' assets are held in order to pay benefits to employees who are many years from retirement and whose pensions do not come due for decades. Consequently these funds do not need all their assets to be liquid and can more

confidently invest in the stocks of private firms than the average individual who must worry about unexpected cash needs.

Second, multi-billion dollar pension funds have the resources to analyze, invest and monitor a large enough number of deals so that it can achieve adequate diversification. The average individual does not.

Third, if institutions do not wish to invest in individual deals, they are at a comparative advantage in dealing with intermediaries. An individual who wishes to buy into a limited partnership that invests in buyout deals must pay a steep 8 percent or so commission to a broker²⁸ to get in and has no voice in the operation of the partnership thereafter. Large institutions have the clout and resources to negotiate more equitable deals, investigate the antecedents of the promoter more thoroughly and monitor the performance of the investments made more closely.

Consequently the pension funds of corporate giants such as General Electric, Eastman Kodak, AT&T and GTE as well as some state funds such as those of Oregon, Washington, Minnesota and Iowa became active investors both in individual deals as well as in pools put together by buyout promoters. In a matter of months in 1985, KKR was able to raise \$2 billion, Forstmann-Little \$1.5 billion, and the investment banks \$2 billion. By 1987, a total of \$15 billion of institutional funds had been committed to the buyout business.²⁹ And as the boutiques and investment banks came to play the role of money managers as well as deal makers, they could bid for sizable businesses with even greater speed since they no longer had to assemble a new set of investors for every deal.

²⁸ Typical deals that have been sold to retail customers have been the Lee-Merrill Lynch and the E.F. Hutton funds.
²⁹ Fortune 2/29/88 p46

3.3 Availability of debt

The purchasing power of the promoters' equity pools was further magnified by the increased availability of debt. Lenders not only overcame their reluctance to advance funds to private firms, they were willing to tolerate leverage ratios far in excess of what had been previously considered prudent even for public companies. Debt to capital ratios in most buyouts were usually in excess of 80%, and 5% equity deals were not unknown.³⁰

New York "money center" banks, who were in the business of "wholesale" lending, became keen providers of the senior (or the secured) debt for buyouts. Their traditional customer base was shrinking -- large corporate customers had defected to the public debt markets and to keep their business would have required the banks to cut their profit margins to the bone. Sovereign borrowers like Argentina and Brazil were less price sensitive, but had become, as even the most optimistic bankers had to concede, less than creditworthy.

Efforts had been made to tap the mid-size company market but progress was slow and the money center banks were not set up to lend small amounts of money to a large number of borrowers. And shrinking was not an option -- a bank like Manufacturers Hannover had to increase its U.S. profits to offset its deteriorated portfolio of Latin American debt. Hence the opportunity to place large secured loans in buyout deals at 1 percent over prime was very attractive.

The senior debt that could be raised was however limited to the value of the assets that could be pledged to the lender and rarely exceeded 50 percent of the funds a promoter had to raise. The more significant development from the point of view of the promoters was the growth of the junk bond market which provided the next 30 to 40 percent of the total capital, in the form of unsecured debt.

³⁰ The Macy's buyout for example actually resulted in a firm with *negative* tangible net worth -- the equity put into the deal was slightly less than the transaction costs incurred.

Michael Milken of Drexel Burnham Lambert virtually invented the junk bond market. The story has often been told: as an M.B.A. student, Milken happened upon academic studies³¹ which showed that the prices of bonds which had lost their investment grade rating traded at excessively low prices. These "fallen angel", "junk" bonds could provide investors with high yields as well as the opportunity to make significant capital gains if the bonds were ever upgraded. Of course investors could also lose most of their outlay if the issuer defaulted because, unlike investment grade bonds, these "junk" bonds were not backed by hard assets. The actual default experience of these bonds was however extremely low, since most issuers did have health cash flows and therefore the potential for losses appeared to be minuscule compared to the high yields. ✕

Upon joining Drexel, Milken was able to build a huge business from this academic research. He extolled the benefits of buying junk bonds to any investor who would listen; and, he assured purchasers that Drexel would always provide liquidity for the bonds - if an investor wished to sell, the firm would unfailingly make a bid to buy them.

In time, Milken built a loyal following among a network of investors who found that, as advertised, junk bonds did provide attractive returns and that Drexel was prepared to make bids, even if that meant accumulating a \$2 billion inventory of bonds.

The next step for Milken was to "create" his own junk bonds. Whereas traditional fallen angel junk happened to have high debt to equity ratios because some misfortune had eroded the issuers equity base, Drexel began to issue junk that started with high leverage. Milken convinced his investors that the new junk wasn't any more risky than the old -- neither variety was meaningfully backed by assets, but both were supported by cash flows that were adequate to meet interest payments.

The venture was a stellar success. If there was a conceptual leap in extrapolating

³¹ For example, Hickman (1958), Atkinson (1967) and Fitzpatrick (1978).

from the experience of fallen angels to new buyout junk, investors didn't mind very much. The bonds were issued at very attractive rates -- a typical issue provided about a 5 to 6% higher yield than an equivalent U.S. Treasury bond. Starting from close to nothing in 1981, \$120 billion of junk bonds had been issued by the end of 1986, about a fifth of which was used by promoters to take public businesses private.³²

Issuing junk bonds was more like issuing equity than debt: like stocks, junk bonds carried few of the restrictive covenants commonly found in investment grade bonds or conventional bank debt³³. And, junk bond investors had to be offered returns that were closer to those that have traditionally been provided by stocks rather than by bonds, since the risks faced by investors in junk were similar to those faced by stockholders -- junk bonds had no collateral and holders had to depend upon the business doing well to be paid.

Junk bonds did however offer buyout promoters three significant advantages over real equity. The first and most obvious was that the tax code favored the use of junk debt, since payments on debt are deductible. Second, junk bonds helped meet the needs of institutions like thrifts who were keen on high risk high return assets, but were constrained by regulation from building a large stock portfolio.

Third and probably the most important, was that a capital structure with 50 percent equity was potentially more disruptive in a private firm than a capital structure with 10 percent equity and 40 percent pseudo equity i.e. junk debt. Junk bonds investors did not have, either by right or by circumstance, much influence over the management of the firm. As long as they received their annual 12 or 15% coupon payments, junk bond holders did not have to be sold on the firms long term strategy. By assuming the same

³² Institutional Investor estimate. Drexel's own numbers are different.

³³ For example, there is usually no restriction on the senior debt that can be assumed "above" the junk debt.

kind of passive role usually played by stockholders of large public companies, junk bond holders allowed promoters of private businesses to limit active ownership to a small cohesive group.³⁴

4. CONCLUSION AND CAVEATS

I have tried in this chapter to show that the purchase by private groups of the units divested by raiders is not accidental and has some value. Public ownership of firms does not represent the zenith of economic development. In fact, public ownership poses significant problems in monitoring managers, and as businesses mature, private ownership is probably more suitable.

Mature businesses in public hands however, may not autonomously transform themselves to private ownership. Raiders, buyout promoters, institutional investors and junk bond investors should therefore be applauded for playing critical roles in overcoming institutional inertia.

There may be a dark side though to the contribution that the buyout groups make. It is not clear that the promoters and their financiers are motivated only by the efficiencies of private ownership. There is, as we will see in the concluding chapter, some reason to believe that participants in buyouts are betting on the greater fool theory -- they expect to make most of their profits by flipping businesses back into public ownership, to stockholders who have no memory or understanding of the need for close monitoring of managers.

These expectations undermine the sustainability of buyouts. Greater fool investors

³⁴ The high leverage offered by junk bonds may also have helped solve the free cash flow problem described by Jensen; however, this advantage is not germane to our discussion since it applies to both public and private companies.

may drive prices for deals to much higher levels than can be justified by improved efficiencies. Some of these investors may get burnt, and in the process, retard a valuable trend in American industry by discouraging other investors.

Chapter 6: Summary and Implications

Let us briefly review what we have learned so far. Most of the empirical findings about hostile takeovers, described in Chapters 2 and 3, can be traced to the backgrounds and identities of the raiders. The typical raider, we saw, is a self made entrepreneur or deal maker, not a manager who has been promoted to the top of a large corporation; his acquisition vehicle is usually just a shell organization. Consequently, we found, most hostile deals stand on their own -- unlike typical friendly mergers, hostile takeovers are usually not undertaken in order to realize the portfolio or synergistic benefits of folding targets into acquiring firms.

In addition, as an independent operator, the typical raider does not have access to discretionary corporate funds -- he has to raise financing, usually through junk bonds, deal by deal. Consequently, the raider has to convince investors in the junk bonds of the economic soundness of each deal. And the need to produce a credible business plan usually precludes takeovers based on:

- o Acquiring companies at a "cheap" price. The raider has to be more than a stock picker -- financiers do not need him merely to buy undervalued stocks for them. Besides, it would be unreasonable to expect that an entire firm could be bought at a throwaway price after paying a acquisition premium and incurring considerable legal expenses. And, in fact, our data did show that by most conventional valuation standards, acquisition prices are not cheap.
- o Cutting back on long term investment. Raiders would have a hard time making a credible case for acquiring high growth, high investment targets. Such companies are difficult to value since their stock prices are heavily weighted by

the profits that current investments are expected to produce in the distant future. Besides, the value of high growth firms is often tied to the motivation of employees, which is at risk in a hostile takeover. Therefore, as we have seen, typical targets are companies in mature businesses that are not doing much investment to start with, and significant investment cuts do not usually follow a hostile takeover.

- o Turning around troubled companies by cutting costs or wages. Assessing the probability of success of rescuing distressed firms is a risky proposition under any circumstances -- rescuers usually find problems they had not initially anticipated. Attempting a turnaround through a hostile transaction, where the raider does not have access to the target's books, would be an extraordinary gamble. Furthermore, the average raider does not have the operating experience necessary to convince investors of his ability to pull off a rescue. Therefore, we do not find raiders picking on a distressed Chrysler, Continental Illinois or Texan thrift -- the targets of hostile takeovers are firms with mediocre performance but not those who are bleeding to death. And, the record indicates, the extensive job and wage cuts that are typical of a turnaround project, do not follow most hostile takeovers.
- o Assuming permanently high levels of debt. Junk bonds used in hostile takeovers are intended only as bridge financing. Investors in takeovers are interested in being repaid quickly, not in holding the paper of firms permanently on the edge of bankruptcy. And again, the record indicates that the junk debt used in hostile takeovers, is quickly paid down.

The true basis of hostile takeovers lies in splitting up diversified companies. Raiders seek "arbitrage" profits by selling the constituent businesses of target companies, often in the "private" market, for more than they pay for the entire company. The enterprise leverages the raiders' deal making skills but does not require operating expertise. The payback to raiders and their financiers is quick, and the economics of a bust-up can be estimated without recourse to the target's internal data.

Friendly takeovers, we found, represent a study in contrast. They are engineered by the managers of established companies. Since friendly acquirers usually have the standing to issue equity or investment grade debt, they rarely utilize junk bond financing. Consequently the economics do not have to be immediately compelling -- the acquisition of overpriced growth companies can be justified by invoking a long term strategic goal. And most frequently, the goal in question is the advancement of some portfolio strategy -- the addition of high-technology, growth, energy or some other type of business to the confederation that constitutes a modern diversified firm.

So where hostile takeovers reduce diversification, friendly takeovers increase it; where hostile takeovers dismantle the corporate staffs that manage unit managers, friendly takeovers expand their powers; and, while hostile takeovers often transfer ownership of businesses from public to private hands, in friendly takeovers, public firms often absorb private ones.

In fact, the data suggest, if it weren't for friendly acquisitions there wouldn't be very many hostile takeover attempts -- firms become targets for split-up arbitrage, by virtue of their previous acquisition activity, not because of the businesses they have developed from within.

Neoclassical economic theory would suggest that since bust-up hostile takeovers have been profitable, they are a value creating activity and friendly takeovers are not.

But what if the neoclassical assumption of rational economic actors don't hold? What if break up profits are due only to the inflated expectations of the buyers of the businesses sold off?

As there is no satisfactory empirical answer to this question, I attempted, in Chapters 4 and 5, to analyze whether value is created by divestiture and privatization, from first principles. In chapter 4 I argued that whatever the merits of diversification may once have been, with the increasing sophistication of U.S. capital markets, the single business firm now represents a more efficient form of organization. In chapter 5 I attempted to show that public ownership is desirable for growth firms that frequently need to raise new capital, while private ownership is better suited to mature businesses that throw off cash, (which are typical of the units spun off by raiders.) To the extent then that the logic of my arguments in Chapters 4 and 5 is sound, we may conclude that hostile takeovers increase economic efficiency, while the majority of friendly takeovers, which increase unrelated diversification, do not.

Several implications arise out of this work for managers, investors, public policy and for further research. Let us discuss these in turn.

1. IMPLICATIONS FOR MANAGERS

Different types of managers are affected differently by hostile takeovers. The findings of this research should comfort operating managers while giving pause to corporate executives.

1.1 Operating Managers.

Raiders usually do not pose a threat to "hands on" operating managers of individual businesses since most raiders have little incentive or ability to intervene in operational matters. In fact, the raider who buys a diversified company with the intention of selling

off its units needs the cooperation of the managers of the units. This is because many potential buyers of divested units (e.g. the LBO funds) do not have hands-on management capability, and would be reluctant to purchase businesses without competent managers in place. Often these buyers will give operating managers a significant equity stake to encourage them to stay and to do a good job. So operating managers could even look upon raiders as benefactors who liberate them from corporate bureaucracies and help set them up as partners in the business they manage rather than as adversaries.

1.2 Corporate Executives

The positions of corporate level executives on the other hand appear to be in some jeopardy. The function they serve -- of monitoring performance and allocating resources -- now appears to be better performed by external capital markets. This is not necessarily a reflection on the lack of competence of the executives, but rather on the growing competence of external markets -- a development over which managers have no control. And short of voluntarily splitting up their companies and thus extinguishing their own jobs, it is not apparent, at least to me, how corporate executives can reliably protect themselves against raiders.

On the margin however, corporate executives may be able to reduce the vulnerability of their corporations to arbitrage type hostile takeovers by following a toned down version of the raiders' strategy. Such a program might include:

- 1. Reducing the number of corporate employees.* The costs and inefficiencies introduced by the corporate office may cause the diversified corporation to be valued by the stock market at less than the sum of its parts. This "conglomerate discount" may be reduced by cutting the number of corporate employees to an absolute minimum.

2. *Narrowing the scope of the corporation.* The conglomerate discount may also be reduced by restricting a diversified corporation's activities to a group of related industries for two reasons. First, security analysts are specialized by industry, and diversified firms which do not fall into any clear industry category tend to get ignored or only superficially analyzed. And, all other things being equal, poorly followed (or misunderstood) firms are more likely to be out of favor with institutional investors and therefore to be cheaply priced with respect to their component businesses.

Second, focusing on a narrow range of industries may allow the internal capital markets to allocate resources and monitor performance more effectively. A corporate staff that focuses on say, just the "leisure time" industry is more likely to achieve parity of expertise and information with "outside" industry analysts than a corporate staff that oversees entirely unrelated businesses.

It may also be claimed that focusing on related businesses opens opportunities to realize synergies by "exploiting interrelationships between businesses." I am not at all sure. However valuable the interrelationships may look on paper, in practice corporate attempts to mandate cooperation between units can create a stifling bureaucracy¹, in which coordination becomes an obsessive goal rather than a means to an end. And where cooperation is truly useful, there is little evidence that independent firms are any worse at pooling resources than the units of diversified firms. The different businesses within IBM for example, have not been shown to cooperate to better effect in setting standards than, say, Sun Microsystems and Xerox.²

3. *Leasing instead of owning assets.* Hard assets such as real estate can also be a source of a version of the conglomerate discount. Stockholders do not need firms to

¹ See Peters and Waterman (1982).

² See Salter and Weinhold (1979), Chapters 7 & 8.

invest in real estate on their behalf any more than they need firms to create a diversified stock portfolio. Consequently the stock prices of firms like Allied and Federated Stores may not fully reflect the value of their real estate holdings. Therefore managers should minimize their firms' ownership of hard assets and lease what they need instead.

4. *Using at least moderate levels of debt.* Maintaining high levels of unused debt capacity is as wasteful as holding high levels of raw material inventory, and an additional attraction to raiders seeking arbitrage profits. If a diversified firm has very little debt, it becomes especially easy to raise takeover financing against the value of its assets.³ Therefore, as a defensive measure, managers should utilize at least moderate amounts of debt.

5. *Instituting controls and incentives for unit managers to run their businesses at peak efficiency.* The break up price of a firm reflects estimates of value based on aggressive (and perhaps even unrealistic) plans for extracting value from the component businesses. Therefore if corporate executives tolerate "satisficing" performance in the businesses they oversee, the gap between market value and break up value is likely to be wide. In order to narrow this gap, executives need to ensure that *all* their businesses are operated at maximum efficiency, *all* the time. This goal may in turn require incentive schemes for the unit managers that provide exceptional rewards for exceptional performance in their individual businesses. In other words, corporate executives may need to provide the same financial packages for operating managers that LBO funds do.

Managers should recognize that the actions necessary to avoid takeovers today are at odds with past strategies for managerial independence. For example, according to Donaldson⁴, managers have traditionally sought to protect their independence by pursuing

³ It should be noted though that few firms get taken over, purely on the basis their unused debt capacity. This is because targets can recapitalize themselves even after a raider appears.

⁴ Donaldson (1984)

policies of financial self sufficiency. These policies have included maintaining operating slack which could be squeezed in times of need, following conservative debt policies and diversifying into many industries so that corporation would not be hostage to the fortunes of any one business. The traditional strategies may no longer be appropriate because the nature of the threats to managerial independence has changed. In the past, constraints imposed by lenders and competitors were visible and real; disaffected equity holders posed only an amorphous threat. Now, thanks to the existence of raiders, the constituency of stockholders has to be taken more seriously. Financial self sufficiency, achieved by a cash balanced portfolio of businesses or low interest payments may not promote managerial goals if it leads to break up opportunities for raiders.

2. IMPLICATIONS FOR INVESTORS

Investors have reason to be both pleased and disturbed by hostile takeovers. On the one hand, they can thank raiders for handsome takeover premia that are paid for the companies that are taken over as well as for forcing all managers to pay greater attention to shareholder interests.

On the other hand, raiders expose investors' impotence. The very fact that raiders can pay a 30% to 50% takeover premium and still make significant gains demonstrates the degree to which investors have failed to discipline managers. If investors were capable of enforcing their claims, they would be the beneficiaries of the value represented by takeover premia and raiders' profits -- by relying on raiders to induce corporate restructuring, investors realize only a part of the potential value of the firms they own.

Although investors are constrained by laws and regulations, much of their impotence is of their own making. As the raiders have shown, owners of many large firms do not need great operating or industry skills to create value -- a few critical decisions can have great leverage. And stockholders, particularly the large institutional

investors, could begin to influence these decisions.

They could start by putting up candidates for boards of directors. Today, most independent or external directors have little reason to vigorously advance the interests of the stockholders they supposedly represent. External directors, many of whom are executives in other large companies, are invited to join boards by management, not stockholders. And, since they rarely hold significant ownership positions, directors are not overly concerned with stock prices -- they serve on boards because of the prestige and contacts it brings or because they want to do their CEO friends a favor.

Directors therefore have much to lose and little to gain by opposing management decisions to, for example, undertake diversifying acquisitions. Directors don't suffer the adverse financial consequences of a bad acquisition, but could find themselves with fewer directorships if they got the reputation for being trouble makers.

Institutional investors could break this cozy arrangement by claiming (as J. P. Morgan used to) representation on the boards of the companies they own.⁵ Or, if institutions are unwilling to take on directorships themselves, they might consider collaborating to elect directors to represent them. The same academics and retired cabinet officers might have a different attitude about looking after the shareholder interest if investors rather than managers controlled entry into the Directors Register.

In the long run, both owners and managers could benefit (at least financially) from boards that truly represented owners. Current owners could realize the entire difference between the current and potential value of a company instead of sharing it with a raider. And, directors who really enjoyed the confidence of shareholders could also structure more compelling incentives for managers. Today, because directors can't be seen to be

⁵ Board representation may however be construed to conflict with the investors' fiduciary responsibilities since it restricts their ability to sell stock quickly. A clarification by the Labor Department that ERISA guidelines would not be violated by board representation would be helpful.

too obviously feathering the nests of their friends, the rewards for superior performance in public companies are often modest compared to those available to managers of LBO's and start-up ventures. Boards who were more independent could structure compensation schemes that provided extraordinary reward for extraordinary performance.

Institutional investors might also consider sponsoring shareholder resolutions that would require diversified firms to divest unrelated businesses. Such resolutions have little impact today because they are initiated by individuals who are widely regarded as eccentric gadflies. Managers would have a much harder time brushing off a resolution that was brought forward by five or ten large shareholders.

Institutional shareholders could further facilitate divestitures by taking equity positions in spin-offs. Participation by existing owners would provide them several benefits. First, split ups of diversified corporations would not be hostage to the state of the divestiture and junk bond market -- it may be noted that after the crash of October 19th, divestiture activity was severely cut back as buyers for spin-offs could not be found. Second, by taking equity positions, institutional investors could keep more of the value added by the de-diversification and privatization of businesses. Third, institutional investors would not have to expend analytical resources to find new investments for the cash they may receive as their current holdings in diversified companies "shrink".

Implementing a strategy of active involvement in firm governance and participation in spin-offs would require most institutions to completely rethink their investment approach. Portfolios of institutional investors today are characterized by high diversification -- an extreme example, Fidelity's Magellan Fund, contains about 1000 stocks - and turnover which averages about 100% a year. Investors' preference for liquidity and therefore for the stocks of large companies with significant outstanding float is great. Stocks are treated as pieces of risk-reward rather than as ownership rights in real

companies; and investors who are unhappy with managers would rather sell their stock than intervene.

Investors active in firm governance will have to behave very differently. Diversification will have to be scaled back; since investors will have to pick the situations they want to get involved in carefully and monitor their holdings closely, they will not be able to hold more than a few dozen stocks.⁶ Turnover will have to decline -- a commitment to participating in firm governance requires staying with a stock for the long haul. Preferences for liquidity (which we saw in the last chapter institutional investors don't really need to have) will have to be abandoned -- businesses spun off from a diversified firm, may, even if they are publicly traded, have low outstanding float and be relatively illiquid. And finally, if investors are unhappy with managers, they will have to look to the rights of ownership that are associated with stock certificates, not the right of free alienability.

3. IMPLICATIONS FOR PUBLIC POLICY

Until recently, public policy on takeovers has been guided by two objectives -- the preservation of competitive market structures and "fair" treatment of the shareholders of target companies. Three pieces of federal legislation have supported these objectives -- the Sherman and Clayton Acts, aimed at preventing anti-competitive combinations of businesses, and the Williams Act, intended to protect shareholders.

Hostile takeovers have raised a new set of concerns and calls for new legislation. Extended hearings have been held in Congress with a view to regulating hostile takeovers, and legislation has already been passed by some state legislatures. There are two sets of concerns about hostile takeovers. First it is believed that hostile takeovers have adverse economic consequences that were not anticipated by the Sherman and

⁶ Which would still provide adequate protection against unsystematic risk.

Clayton Acts: although the takeovers usually do not lead to anti-competitive combinations, critics claim they weaken the economic fabric of industry in all the other ways that were described in Chapter 3.

3.1 Efficiency Issues

States like New Jersey have therefore passed laws aimed at curtailing the "bad" consequences of hostile takeovers. The New Jersey law for example, prohibits raiders from selling off assets to pay down debt incurred in takeovers. Critics of hostile takeovers, like Lloyd Cutler⁷, have also called for Federal legislation to limit the interest deduction for debt used in takeovers. And there have been suggestions that the ownership rights of "new" shareholders be restricted so that raiders would find it difficult to gain control of target companies quickly.⁸

A second concern is that existing legislation does not adequately protect target shareholders from the new takeover tactics devised by the raiders. The small shareholder, it is claimed, may be forced to sell out at too low a price by coercive two-tier offers⁹ and market sweeps¹⁰. Remedies that have been proposed to ensure that all shareholders get a fair price include a reduced time period for 13(d) filings and a ban on two tier offers and sweeps.¹¹

My research suggests that most concerns about adverse economic consequences are misplaced and that "arbitrage type" hostile takeover should not be discouraged. Restrictions on the use of junk debt and on divestitures appear to be particularly inimical to the public interest. Without junk bonds, "outsiders" would not be able to bid for the control

⁷ Testimony in Congressional Hearings on Hostile Takeovers (1987) p 65.

⁸ See testimony of Rohatyn and observations by Sen. Chafee (p 63) in Congressional Hearings (1987) on Hostile Takeovers.

⁹ In which the raider tenders for a controlling interest of the outstanding stock at an attractive price and pays a lower amount for the rest later

¹⁰ Whereby a raider buys a controlling interest from a selected number of institutional investors instead of making a tender offer to all stockholders.

¹¹ See testimonies of Brady (p34, 59) and Rohatyn (p. 63) in Congressional Hearings (1987) on Hostile Takeovers.

of the large corporations that need to be reconfigured. Too, the junk bond investors force raiders to undertake takeovers that have a clear economic benefit - unlike managers who undertake traditional friendly takeovers, the raiders cannot to take on uneconomic deals merely to stroke their egos.

As far as the restrictions on divestitures are concerned, little more need be said. The single most important contribution of hostile takeovers is that they cut down on corporate sprawl, and bring more focus to U.S. industry.

3.2 The Fairness Issue

Analysis of the fairness question is more problematic and there are no simple answers to what public policy should be. At the crux of the issue is how the value created by splitting up diversified firms should be shared between raiders and target shareholders. Two tier offers, market sweeps and the like give the raider (and, to a lesser extent, large institutions) a greater share of the value created. Reduced periods for 13(D) filings¹² and single price tender offers for all outstanding stock give target stockholders a greater share of the pie, and do not discriminate between large and small investors.

Both the raiders and target shareholders can make plausible claims for themselves. The raiders can claim that since they take all the risks and do all the work, they should get the full benefit of the value created. On the other hand, shareholders could claim title not only to the value of their firm as it is currently managed and configured, but also to its potential value under a different management and strategy. If a raider can force shareholders to sell out at a price which reflects only the stock market's valuation of the firm under its current and "expected" strategy, then the shareholders may lose the "option" value of a possible change in strategy.

¹² Brady has proposed that the filing window be reduced from 10 days to 2 days. (*Hearings* (1987)); however Prof. Stevenson argues that given the time it now takes to settle trades, ten days is, for all practical purposes, immediate.

The problem may be clarified by an example. Suppose we have a diversified firm with a break up value of \$150 per share. The market does not however believe that current management has any intention of divesting assets, and so the stock trades at only \$100/share. If a raider could buy the firm from current shareholders at \$100, the shareholders may claim they have lost \$50 of potential value. But if raiders were forced to pay \$150 per share, they wouldn't be interested in splitting up the firm.

The problem would not exist if the stock market was perfectly efficient. If, in the above example, the \$100 stock price reflected not only the value of the firm under its current strategy, but also the possibility that the strategy could be changed, and the \$50 difference between break up and market value reflected only the costs and uncertainties of a break up, shareholders would have no reason to complain. But in fact few people, especially in the investment community or judiciary believe that the stock market puts the right price on the option value of a change in strategy and disputes about fair value in takeovers are commonplace.

The fairness problem would also not arise if the market for corporate control was perfectly competitive. If for example, shareholders could set up an auction for the right to acquire and break up their firm and many competent bidders participated in this auction, then there would be no reason for shareholders to feel cheated. But again in the real world, these conditions do not obtain. There are only a handful of raiders who have the know-how and the credibility with financiers needed to acquire large diversified firms. And the bidding process itself does not resemble a smoothly functioning auction. The auctioneers -- the incumbent board and management -- are often more interested in preventing a takeover than in getting the best possible price for their shareholders. Competing tender offers rarely expire at the same time, and investors may be forced to tender into a lower offer that expires first.

These institutional factors make it difficult to formulate a public policy that adequately protects the rights of stockholders on the one hand but does not so cut into raiders' profits as to deter them from attempting takeovers.

3.3 Improving Firm Governance

The whole question of regulating hostile takeovers would be largely moot if it weren't for friendly mergers. If public firms hadn't so actively diversified through acquisition or were now more willing to divest the unrelated businesses they had previously acquired, we wouldn't have to worry about the fair treatment of target shareholders.

The problem of value-destroying friendly mergers would in turn be much less serious if we had an effective system of firm governance in place. If shareholders were properly represented by boards of directors, fewer uneconomic friendly transactions would take place and past acquisition mistakes would be quickly rectified. In fact, as the still very high level of friendly takeovers indicates, managers continue to enjoy considerable freedom from pliable or disinterested boards. And the most important challenge for public policy is not the design of new laws to ensure a fair bidding process in hostile takeovers, but rather the establishment of boards of directors who truly represent shareholder interests.

Reform of the election process would be a major step. Today, an official slate of directors is proposed by incumbent managers and is almost always elected unopposed. In the rare circumstance that someone actually challenges the official slate of candidates, incumbent managers inevitably retain a law firm, a PR firm and an investment bank to fight the upstart; and while the challenger has to pay his own expenses, the tab run up by the incumbent managers is picked up by the shareholders. Finally, if the matter does

come to a vote, there is rarely a secret ballot. Institutional investors who manage pension funds for large corporations may therefore be reluctant to vote against the official slate for fear of being labelled as anti-management by their other clients.

A similar process in the political arena, most people would agree, would not produce a very representative form of government. If the existing Congress and Executive offered an official slate of candidates, incumbents routinely sued opponents, using public funds to pay their legal fees, and voting were not by secret ballot, we probably wouldn't have a government for the people. Likewise it is fair to assume that the current election process does not ensure a board of directors dedicated to protecting the shareholder interest.

Three changes could bring about greater shareholder democracy. First, the abolition of official slates of candidates - incumbent directors and managers would of course be free to nominate candidates but only in their capacity as shareholders. Second, a prohibition on the expenditure of firm funds to protect the seats of incumbent directors in proxy fights. And third, the institution of a secret ballot on all shareholder votes. These changes would still leave existing managers and boards with several advantages of incumbency, but the playing field would be more level and the threat of retribution for anti-shareholder policies would be greater.

Public policy could also improve firm governance by working on the incentives and attitudes of institutional investors. Today, the stockholders who are best positioned to play an effective role in firm governance -- institutional investors -- are reluctant to do so. And although the onus for change lies mainly with the institutional investors themselves, public policy could nudge them along. By discouraging turnover and excessive diversification of their portfolios, public policy might induce institutional investors to look at their stocks from an owner's perspective.

The most direct approach to reducing turnover and diversification would be through taxes on transactions or punitive taxes on short term gains, for all investors, including those institutions who now enjoy tax exempt status. Higher costs of getting into and out of a stock might induce institutional investors to analyze and monitor their investments more diligently, and therefore to hold fewer stocks for longer periods. The investors would then at least be in a position to play a meaningful ownership role.

The direct approach might however attract so much opposition from the financial services industry (which thrives on high turnover) that it could not be implemented. Hence a more practical solution might be to re-interpret (and possibly modify) the Employee Retirement Income Security Act of 1974 (ERISA).

Under ERISA, fiduciaries of pension plans are required to ensure that expenses are "reasonable". A simple determination that portfolio turnover that consistently exceeded say, 50%, over several years, entailed unreasonable levels of commission and bid-asked spread costs would be both in keeping with the original intent of the law and would go a long way towards improving corporate governance.

In addition, ERISA could be amended or re-interpreted to change the type of "prudence" it requires of a fiduciary. Under the standard prudent man rule of personal trusts, a fiduciary must ensure that every single item of investment is prudently made. Apparently in "a direct response to modern portfolio theory",¹³ the Labor Department's interpretation of ERISA requires only that an entire portfolio meets prudent man responsibilities. As long as the portfolio is adequately diversified, due diligence on individual securities is not necessary.

This interpretation is probably not in keeping with the intent of ERISA. Portfolio prudence, like portfolio insurance, leans heavily on the behavior of other market

¹³ Vawter, in Magin and Tuttle (1983)

participants and works only on the margin. Adopted by a significant number of institutional investors, it drastically reduces the scrutiny and monitoring of individual securities and increases the risk of poor management of the firms in everyone's portfolio. Applying the traditional prudent man rule to corporate pension funds would improve the general level of due diligence in the market and be more consistent with ERISA objectives. As a bonus it might also lead to better corporate governance as fiduciaries would be forced to pare back the number of stocks they owned and the rapidity with which they turned them over.

4. IMPLICATIONS FOR RESEARCH

The research and analyses described in this thesis raise almost as many questions as they answer. The issues that merit further research include:

1. What happens to the "near targets" of hostile takeovers?

In order to identify an unambiguous population of hostile targets, I looked at only those companies for whom a contested tender offer had actually been made. There are however many firms who attract the attention of an unwelcome suitor who withdraws before making a formal tender offer.¹⁴ The validity of the results of this thesis could be strengthened (or modified) by analyzing a sample of these "near targets".

2. What actually happens to the divested units taken private?

Although a large sample study of the long term consequences of hostile takeovers will be difficult to do, an in depth clinical investigation of a few cases of units taken private would be a worthwhile endeavor. Among the questions that could be addressed are: Were significant changes made in the business strategy, or did new management concentrate on operational improvements? Were long term or short term goals

¹⁴ Because for example, the raider is bought off with a greenmail payment or cannot line up adequate financing.

modified? Were changes made in organizational structure and incentives? What sort of relationship developed between managers and the outside investors? What role did the board of directors play and how was it different from the role previously played by corporate level management? How was employee morale and turnover affected? Was any gulf created between managers who were given significant ownership stakes and those who weren't?

3. What is the proper response to industry maturity?

Slow growth of a firm's revenues and profits as an industry matures often creates severe organizational strains, especially in the managerial ranks. Talented individuals will not accept employment in an organization that is perceived to lack opportunities for advancement. Existing managers may get disgruntled -- according to Penrose¹⁵, managerial capacity expands with learning, and as a business settles into steady state, excess capacity may develop and managers may get bored. At the same time, even a capital intensive, mature business cannot afford low morale and un-enterprising employees. With the possible exception of regulated utilities, firms are always vulnerable to new technology or competition. So quite apart from empire building motives, the economic need for firms in mature industries to grow is strong.

Since growth by building new businesses is uncertain and slow, the preferred route to expansion has traditionally been conquest -- the (usually friendly) acquisition of firms in other faster growing industries. Some managers from the slow growing core business can then be found prestigious slots in the acquired entity while others can be elevated to a newly created corporate level of management.

Diversification through acquisition is no longer a suitable response to the organizational problem of slow growth because of the raiders' persistent search for break up

¹⁵ Penrose (1959)

opportunities. Finding an alternative strategy is a major challenge for mature firms -- perhaps the answer lies in the management of expectations and values so that high quality human resources can be maintained without the carrot of hierarchical promotion. Research into the experience of successful firms in mature service industries such as advertising, law and consulting could provide useful insights.

Another challenge raised by industry maturity is achieving a smoother transition to industry maturity. As we discussed in Chapter 5, private ownership may be better suited for mature businesses than public ownership. However, there may be considerable institutional inertia which impedes such a conversion. This is being overcome today, by the impetus, some observers believe, provided by unrealistic expectations of profits from going private transactions. If this is the case, the impetus may disappear and we may then be faced with the problem of finding alternative institutional arrangements for bringing about the change. In other words, we may need to find a steady source of capital, willing to accept modestly attractive returns rather than windfalls, so as to avoid a "boom-bust" process of privatization. One possible solution (as mentioned earlier) may lie in the willingness of existing public shareholders (especially the institutions) to take the lead in providing the impetus as well as equity stakes in the entity turned private.¹⁶

4. What else could be done to change institutional investors' incentives?

Weaknesses in corporate governance, I suggested in Chapter 4 followed the dilution of family fortunes and the consequent fragmentation of stock ownership. With the emergence of what Drucker calls "pension fund socialism", we have seen some reconcentration of ownership, especially of larger firms and therefore a more even

¹⁶ Another long term solution might be for growing firms to issue zero coupon bonds instead of publicly traded equity. The bonds would have a maturity that would match the expected "life-cycle" of the business and would be paid off when the business reached maturity. (If the issuer was then unable to redeem the zero, the investors would have the right to convert their holdings to equity at a very low price.)

distribution of power between owners and managers.

Even so, it is not clear that pension fund managers (and their fiduciaries) will always press the rights of owners as vigorously as wealthy individuals might. In practice, institutional fiduciaries may not have strong incentives to maximize the long term wealth of their portfolios -- the beneficiaries, in many cases, are not people who actually exist, and trustees derive little reward or gratitude for exceptional returns. Rather, trustees are often most concerned with the perception of prudence, as defined by the performance of their peers. To paraphrase Keynes, they would rather fail conventionally than succeed unconventionally.

Perhaps, a rigorous economic analysis might show, nothing can really be done to ensure true wealth maximizing behavior by pension fund fiduciaries-- sub-optimal firm governance may be an unavoidable cost of egalitarian wealth distribution. But surely man is not motivated by financial reward alone. Surely pride in a job well done, the feeling of having made a contribution to the public weal have a role to play in our economic arrangements. Could we not search for a system of governance be built around these values rather than for one constructed solely on monetary contracts? Research into the governance arrangements in countries like Germany and Japan could suggest alternative, "value based" models.

**APPENDIX TO CHAPTER 2:
SUMMARY OF KEY DATA USED TO INFER ACQUIRERS' EXPECTED
BENEFITS**

Hostile Transactions in 1985.

Target: Crown Zellerbach

Acquirer: Goldsmith Acquisition

Nature and source of expected benefit(s): Restr./Invest.

Acquirer's diversification strategy and record:

"Built empire by restructuring and often dismantling the companies he buys." Belief in long term value of timber. Successfully bought one timber company (Diamond International) and made a run at two others. In the case of Diamond Intl., purchased timber at less than its market value and recovered investment by selling other operating properties.

Commitments made/ Plans announced before takeover: Spin off non-timber assets

Acquirer/Target Business overlap: None

Analysts comments:

"Paper companies are seen as good takeover targets since their timber land assets are generally undervalued."

Acquiring organization: Private investment vehicle

Target: American National Resources

Acquirer: Coastal Corp.

Nature and source of expected benefit(s): Restructuring

Acquirer's diversification strategy and record:

Chairman Oscar Wyatt, reputedly single handedly responsible for causing the restructuring of the natural gas pipeline industry; also record for bidding on out of favor assets. Bid for Houston Natural Gas, Sonat Corp., Skyline Coal from Getty, Refinery from Texaco, assets of Transamerican Natural Gas which were then in bankruptcy.

Commitments made/ Plans announced before takeover:

Agreed to retain most of ANR employees and its Detroit headquarters and operations for two years.

Acquirer/Target Business overlap: Same industry

Analysts comments:

"CGP super leveraged the purchase; paid an anti-dilutive price"

Acquiring organization: Public company

Target: Revlon Inc.

Acquirer: Pantry Pride

Nature and source of expected benefit(s): Restructuring

Acquirer's diversification strategy and record:

According to a Pru Bache analyst: "what Perlman likes doing - and what he is good at - is buying companies. His strategy: buy a company with "poor fitting" pieces, sell them off to reduce purchase price. Then exploit the remaining cash generating pieces." Accordingly, Perlman acquired and divested most of Pantry Pride, attempted a bust up raid of Frigitronics, and attempted a takeover of Gillette.

Commitments made/ Plans announced before takeover:

Sell units worth 70% of acquisition price

Acquirer/Target Business overlap: Overlap in some businesses

Acquiring organization: Acquisition shell company

Target: McGraw Edison

Acquirer: Cooper Industries

Nature and source of expected benefit(s): Port./Restr.

Acquirer's diversification strategy and record:

Unrelated diversification. Acquired Turner Industries, computer cable division from Phalo Corp, Crouse Hinds, petroleum equipment business from Joy. Attempted turnaround of acquisitions. According to an Oppenheimer analyst, "the company has previously managed similar large acquisitions, improving margins by nearly 50%".

Rationale offered for attempt:

Move into electrical and electronic products to decrease dependence on compression and drilling products

Commitments made/ Plans announced before takeover:

One or two divisions might be sold to reduce debt.

Acquirer/Target Business overlap: Some overlapping products- fit with Cooper's electrical equipment and hand tools.

Acquiring organization: Diversified public company

Target: Pacific Lumber Co.

Acquirer: MAXXAM Group Inc.

Nature and source of expected benefit(s): Restructuring

Acquirer's diversification strategy and record:

Restructuring motivated acquisitions/attempts include AMF, Alamito, UNC Resources and Castle and Cook.

Commitments made/ Plans announced before takeover:

Accelerate harvesting, sell welding operations and some timberland acreage.

Acquirer/Target Business overlap: None.

Acquiring organization: Closely held investment shell

Target: Southland Royalty Co.

Acquirer: Burlington Northern Inc.

Nature and source of expected benefit(s): Portfolio

Acquirer's diversification strategy and record:

Diversify into natural resources. Acquired El Paso (a gas company) and Meridian Oil. CEO of acquirer brought in from ARCO, following a contrarian strategy of increasing acquisitions and exploration expenditures in the face of falling energy prices. Reportedly skilled at cutting costs.

Rationale offered for attempt:

"Good time to buy oil and gas since, when there are few competing buyers, assets are cheap".

Commitments made/ Plans announced before takeover:

Acquirer/Target Business overlap: Partial overlap - Southland a large supplier for acquirer's pipeline.

Analysts comments:

"Although we believe Burlington Northern did no overpay for Southland, neither was the acquisition a steal as evidenced by the fact thatno one emerged to outbid BNR" (Kidder Peabody)

Acquiring organization: Diversified public corporation

Target: AMF Inc.

Acquirer: Minstar Inc.

Nature and source of expected benefit(s): Restructuring

Acquirer's diversification strategy and record:

Jacobs called "Irv the Liquidator". Reputation for buying companies and selling off pieces to pay for the acquisition. Restructuring motivated acquisitions/attempts of Aegis Corp., Disney, Borg-Warner and Castle and Cook.

Commitments made/ Plans announced before takeover:

Sell half of assets, cut costs, run a decentralized operation.

Acquirer/Target Business overlap: Some, in boating operations.

Acquiring organization: Closely held quasi-investment vehicle.

Target: SCM Corp.

Acquirer: Hanson Trust PLC.

Nature and source of expected benefit(s): Restructuring

Acquirer's diversification strategy and record:

According to a former Hanson executive Robert Cowell, Hanson's key to success is "to buy at low price, sell off money losing businesses, trim overhead, and concentrate on the acquired company's most profitable parts". Recent examples: Berc Ltd, UDS Group, Ames Company, U.S. Industries and ICI.

Commitments made/ Plans announced before takeover:

Reduce \$24 million in corporate charges, install profit incentives, sell off assets.

Acquirer/Target Business overlap: None

Acquiring organization: Diversified public conglomerate.

Target: Informatics General Corp.

Acquirer: Sterling Software Inc.

Nature and source of expected benefit(s): Syn./Restr

Acquirer's diversification strategy and record:

Acquisitions in the software industry. Acquired Pacesetter Systems and Decision Systems. Reputation for "streamlining, including drastic cost cutting at its newly acquired companies".

Commitments made/ Plans announced before takeover:

Divest some assets, reorganize to integrate operations.

Acquirer/Target Business overlap: Same industry.

Acquiring organization: Public company.

Other: Numerous "restructuring" raiders (e.g. MAXXAM) held stakes in target, but did not make a formal bid.

Target: Great Lakes International

Acquirer: Itel Corp.

Nature and source of expected benefit(s): Restructuring/investment

Acquirer's diversification strategy and record:

Samuel Zell, self proclaimed "grave dancer". Preference for deals in depressed industries (e.g. Great American Management, distressed real properties) with strong cash flows that could be substantially levered up.

Commitments made/ Plans announced before takeover:

Increase investment in operations. Offer to negotiate employment and incentive arrangements with managers.

Acquirer/Target Business overlap: None

Acquiring organization: Closely held investment vehicle.

Target: Easco Corp.

Acquirer: ES Acquisition Corp.

Nature and source of expected benefit(s): Restructuring

Acquirer's diversification strategy and record:

Acquiring partnership included Samuel Zell. See Great Lakes - IteI

Rationale offered for attempt:

"Fundamental business is quite solid".

Commitments made/ Plans announced before takeover:

Sell off hand tools business.

Acquirer/Target Business overlap: None

Acquiring organization: Private partnership

Target: Midcon Corp.

Acquirer: Freeport McMoran/ Wagner & Brown

Nature and source of expected benefit(s): Restructuring

Acquirer's diversification strategy and record:

Freeport's record: Acquire and restructure natural resource companies by divesting or spinning off assets to shareholders. Acquisitions of Stone Exploration Corp., Midland Energy Corp. Bid for Petro Lewis Partnerships on the verge of bankruptcy. W & B's record: Participated in many Boone Pickens's transactions such as the attempted takeovers of Gulf, Philips Pete. and Unocal.

Rationale offered for attempt:

"Buy cash flow generator that can be leveraged up". Freeport management estimated that its 30% interest in Midcon would have generated \$150 million in net income and \$200 million in free cash flow after 10 years.

Commitments made/ Plans announced before takeover:

Offered incumbent managers 5% equity interest in surviving firm.

Acquirer/Target Business overlap: NA

Acquiring organization: Private partnership

Target: Richardson Vicks.

Acquirer: Unilever PLC.

Nature and source of expected benefit(s): Synerg./Port.

Acquirer's diversification strategy and record:

Acquisition of consumer goods companies worldwide including Brooke Bond, Beatrice Foods' Shedd Margarine Group. Planned acquisitions to expand U.S. presence.

Rationale offered for attempt:

Acquirer/Target Business overlap: Yes, similar channels.

Acquiring organization: Public company

Target: Uniroyal Inc.

Acquirer: Carl Icahn

Nature and source of expected benefit(s): Restructuring

Acquirer's diversification strategy and record:

Restructuring/ liquidation raids on Hammermill Paper Company, Marshall Field, Dan River, American Can, and TWA.

Commitments made/ Plans announced before takeover:

Divest non-tire assets

Acquirer/Target Business overlap: None

Acquiring organization: Private investment vehicle

Target: Cluett Peabody

Acquirer: Paul Bilzerian

Nature and source of expected benefit(s): Restructuring

Acquirer's diversification strategy and record:

Nature and source of expected benefit(s): Restructuring

Several restructuring raids. Acquired Reed International's Arthur Sanderson & Sons. Bid for Pick 'N' Pay. Acquired Singer. Teamed up with DeBartolo to bid on Allied Stores.

Commitments made/ Plans announced before takeover:

Expand Arrow label, use Cluett Peabody as vehicle for future acquisitions.

Acquirer/Target Business overlap: None

Analysts comments:

"We feel the prime objective would have to change towards maximization of cash flow and the repayment of debt (perhaps by the partial liquidation of the company)". Drexel Burnham Lambert analyst.

Acquiring organization: Private investment vehicle

Target: Frontier Holdings

Acquirer: Texas Air

Nature and source of expected benefit(s): Rstr./Syn.

Acquirer's diversification strategy and record:

See Continental - Texas Air.

Rationale offered for attempt:

Build low-cost national airline.

Commitments made/ Plans announced before takeover:

Operate as separate airline but establish joint marketing, frequent flier programs.

Acquirer/Target Business overlap: Same industry.

Acquiring organization: Public company.

Target: Unidynamics Corp.

Acquirer: Nortek Inc.

Nature and source of expected benefit(s): Portfolio

Acquirer's diversification strategy and record:

Growth through unrelated acquisitions. Bid for/acquired Monogram Industries in 1983, Music & Sound Inc. in 1983, Monarch Metal (1983), Amerace Corp., Spalding Fiber Co., Jensen Industries, Woodhead, Transway International Corp. Some deals made with block purchases from management. Occasional greenmail profits. Pieces of acquisitions sometimes sold off thru' LBOs.

Commitments made/ Plans announced before takeover:

Disposal of Unidynamics' merchandising equipment and industrial systems segments.

Acquirer/Target Business overlap: None

Acquiring organization: Diversified public company

Target: Hook Drugs Inc.

Acquirer: Rite Aid

Nature and source of expected benefit(s): Synergistic

Acquirer's diversification strategy and record:

Rapid geographic expansion in drug stores through acquisitions including Harris Drugs, Super Rx Drugs, Great Drug Fair, Muir (drugstore chain in Michigan), 103 drugstores from Sherwin Williams. Record of integrating and upgrading acquired chains.

Rationale offered for attempt:

"Expand base in Indiana where Rite Aid has only three drugstores".

Acquirer/Target Business overlap: Same industry

Acquiring organization: Public company

Target: J.M. Tull Industries

Acquirer: Bethlehem Steel

Nature and source of expected benefit(s): Portfolio

Acquirer's diversification strategy and record:

Following example of other steel industries to diversify out of industry. Retained consultant to find non-steel acquisitions.

Rationale offered for attempt:

"Become a leading supplier of materials, equipment and services to industrial America".

Acquirer/Target Business overlap: Target distributor of steel products of acquirer.

Acquiring organization: Public company

Target: Midcon Corp.

Acquirer: Occidental Petroleum (White Knight)

Nature and source of expected benefit(s): Portfolio

Acquirer's diversification strategy and record:

Wide ranging acquisitions including Cities Services, Arm & Hammer, Iowa Beef, Wilson Foods Corp. As of 1983, acquiring domestic reserves seem to be priority. Bought back shares from large stockholder at considerable premium to neutralize challenge to Chairman Armand Hammer.

Rationale offered for attempt:

"Complement and supplement our gas operations because a large portion of our gas reserves are shut off from the market".

Commitments made/ Plans announced before takeover:

Davis of Midcon to stay as CEO and run Midcon as separate subsidiary for 3 years.

Acquirer/Target Business overlap: Target potentially a transporter of Cities' gas.

Acquiring organization: Diversified public company

Target: Richardson Vicks

Acquirer: Proctor & Gamble (white knight)

Nature and source of expected benefit(s): Synergy

Acquirer's diversification strategy and record:

Related industry acquisitions. Trying to enter new markets with higher growth prospects. Acquired Norwich-Eaton Pharmaceuticals (1982), and Searle's over-the-counter drug business.

Rationale offered for attempt:

Acquirer/Target Business overlap: Similar distribution channels.

Analysts comments:

"May have overpaid on an NPV basis". (Kidder Peabody)

Acquiring organization: Public company

Target: Uniroyal Inc.

Acquirer: Clayton & Dublier/Uniroyal Management (white knight)

Nature and source of expected benefit(s): Restructuring

Acquirer's diversification strategy and record:

Clayton & Dublier involved in numerous restructuring takeovers.

Commitments made/ Plans announced before takeover:

Sell off assets

Acquirer/Target Business overlap: NA

Analysts comments:

Mode of financing makes it virtually certain that Uniroyal will be liquidated.

Acquiring organization: Investment partnership

Target: Cluett Peabody

Acquirer: West Point Pepperell (white knight)

Nature and source of expected benefit(s): Portfolio

Acquirer's diversification strategy and record:

Diversify into branded soft goods, reduce presence in textiles. Accordingly, sold Lindale Mill denim operation.

Commitments made/ Plans announced before takeover:

Keep Cluett's operation basically intact.

Acquirer/Target Business overlap: Little to no overlap.

Acquiring organization: Public company

Target: Frontier Holdings

Acquirer: People Express (white knight)

Nature and source of expected benefit(s): Synergistic

Acquirer's diversification strategy and record:

Geographic expansion of low fare strategy initially through internal growth and later (after '84) through acquisitions (e.g. of Britt Airways and Provincetown-Boston).

Rationale offered for attempt:

Protect competitive position by feeding passengers to each other's airlines. Gain access to Denver gates.

Commitments made/ Plans announced before takeover:

Operate airlines separately but coordinate schedules.

Acquirer/Target Business overlap: Same industry.

Acquiring organization: Public company

Target: Unidynamics

Acquirer: Crane Co. (white knight)

Nature and source of expected benefit(s): Portfolio

Acquirer's diversification strategy and record:

Unrelated diversification: Bid for Medusa Corp. (1983), Aloyco, Jensen Industries, Textone, Dixieline Lumber. Was attempting to "reposition in more profitable growth markets" at the time of Unidynamics acquisition.

Rationale offered for attempt:

Vehicle for entry into energy materials and defense systems.

Acquirer/Target Business overlap: None

Acquiring organization: Diversified public company

Target: Hook Drugs Inc.

Acquirer: Kroger Co. (white knight)

Nature and source of expected benefit(s): Portfolio

Acquirer's diversification strategy and record:

Diversification into drugstores and convenience store. Reducing exposure to lower margin grocery goods. Acquired Dillon Companies (1983), Super Drug Corp., Kroco Inc. (1983).

Rationale offered for attempt:

Management's skills at Hook will benefit existing drugstore operations.

Acquirer/Target Business overlap: Overlap with Super Rx subsidiaries.

Acquiring organization: Public company

Target: J.M. Tull Industries

Acquirer: Inland Steel (white knight)

Nature and source of expected benefit(s): Portfolio

Acquirer's diversification strategy and record:

Adopted holding company structure to separate steel and non-steel assets and to facilitate acquisition of non-steel assets.

Acquirer/Target Business overlap: Distributer of Inland products.

Acquiring organization: Public company

Target: Times Fiber

Acquirer: LBO

Nature and source of expected benefit(s): Restructuring

Acquirer's diversification strategy and record:

N.A.

Rationale offered for attempt:

Management changes needed to stem "further losses".

Commitments made/ Plans announced before takeover:

Sell several assets.

Acquiring organization: Private investment group.

Target: Unocal

Acquirer: Mesa Petroleum

Nature and source of expected benefit(s): Restructuring

Acquirer's diversification strategy and record:

Restructuring raids on several large oil companies including Philips, Diamond Shamrock, Gulf, and Cities; later attempted takeovers of mining and industrial firms.

Rationale offered for attempt:

Shareholder values can be increased by restructuring.

Commitments made/ Plans announced before takeover:

Slash exploration and production budgets; leverage up remaining assets

Acquirer/Target Business overlap: Same industry.

Analysts comments:

Price fully reflects the value of the company.

Acquiring organization: Public investment vehicle and oil company.

Target: Phillips Petroleum

Acquirer: Carl Icahn

Nature and source of expected benefit(s): Restructuring

Acquirer's diversification strategy and record:

Numerous restructuring raids (see Uniroyal).

Rationale offered for attempt:

Company worth more split apart than whole.

Commitments made/ Plans announced before takeover:

Sell \$3.7 billion of assets, assume \$10.8 billion of debt (to \$1 billion in equity).

Acquirer/Target Business overlap: None

Analysts comments:

"Price offered above break-up value" (Value Line)

Acquiring organization: Private investment vehicle.

Target: CBS Inc.

Acquirer: Turner Broadcasting

Nature and source of expected benefit(s): Portfolio/synergistic.

Acquirer's diversification strategy and record:

Growth through acquisitions in entertainment arena - acquired Satellite News Channel (1983), negotiated to purchase ESPN (1984) and bought MGM/UA after CBS deal fell through. Turner also owned majority interest in the Atlanta Hawks and Atlanta Braves.

Rationale offered for attempt:

Commitments made/ Plans announced before takeover: Sell nearly all non-broadcasting assets worth \$1.8 billion.

Acquirer/Target Business overlap: Same industry.

Acquiring organization: Closely held public company.

Target: Union Carbide

Acquirer: GAF Corp.

Nature and source of expected benefit(s): Restructuring

Acquirer's diversification strategy and record:

Heyman won control of GAF in a proxy contest and proceeded to restructure company. Laid off 10% of corporate staff, moved headquarters to Wayne, NJ. and closed three roofing plants.

Commitments made/ Plans announced before takeover:

Sell units that account for 40% of Union Carbide's revenue (consumer products division, metals and carbon product units)

Acquirer/Target Business overlap: Same industry.

Acquiring organization: Public operating industry

Hostile Transactions in 1986.

Target: White Consolidated

Acquirer: A B Electrolux

Nature and source of expected benefit(s): Restr./Synerg.

Acquirer's diversification strategy and record:

Global white goods and other appliance mfg. Strategy of related acquisitions world wide including Tappan (in the U.S), Zanussi (leading Italian appliance mfg.) and nearly 400 other companies in 15 years. According to the WSJ, "credited with many debt, although ruthless turnarounds, accomplished by shedding unwanted assets and making profitable those that are kept."

Rationale offered for attempt:

"We're very anxious to have a broader product line in the U.S."

Commitments made/ Plans announced before takeover:

Sell certain lines that do not fit strategy.

Acquirer/Target Business overlap: Several overlapping lines

Acquiring organization: Multinational public corporation.

Target: Saga Corp.

Acquirer: Marriot Corp.

Nature and source of expected benefit(s): Synergistic

Acquirer's diversification strategy and record:

Numerous acquisitions in the lodging and food service industry including Service systems Corp., food service businesses of Gladieux corp, and Howard Johnson restrants.

Acquirer/Target Business overlap: Same industry.

Analysts comments:

Acquisition will help Marriot sign national contracts with major customers.

Acquiring organization: Public company

Target: Ryan Homes

Acquirer: N.V. Homes

Nature and source of expected benefit(s): Synergistic

Acquirer's diversification strategy and record:

Closed Texas operation in Texas; new CEO looking for alternative growth opportunities in the industry.

Rationale offered for attempt:

Interested in Ryan because of expected growth at the company and complementary nature of their products. "We're building upscale products, they're building the low and moderately priced housing." (CEO Schar)

Commitments made/ Plans announced before takeover:

Leave company intact. Ryan will continue to be headquartered in Pittsburgh.

Acquirer/Target Business overlap: Same industry.

Acquiring organization: Limited partnership

Target: Ponderosa

Acquirer: Asher Edelman

Nature and source of expected benefit(s): Restructuring

Acquirer's diversification strategy and record:

Number of opportunistic takeover attempts of companies reputed to be undermanaged or worth more when split up. Acquired Datapoint and Mohawk Data Sciences; bid for Lucky Stores and Fruehauf.

Commitments made/ Plans announced before takeover:

Sell off meats division and some restaurants

Acquirer/Target Business overlap: None

Acquiring organization: Limited partnership

Target: C.H Masland

Acquirer: Burlington Ind.

Nature and source of expected benefit(s): Port./Syn.

Acquirer's diversification strategy and record:

Cutting back from businesses most exposed to foreign competition -- closed textured woven polyester operation, scaled back production of cord and blended cotton fabric and sold sheet and towel division to J.P Stevens. Seeking opportunities in lines not exposed to imports, especially in automotive sector. Entered a joint venture with Japanese firm to supply Japanese auto firms.

Acquirer/Target Business overlap: Related industry.

Analysts comments:

Burlington "wants very badly to enter the automotive carpeting business to tie into its plans to make automobile upholstery fabrics."

Acquiring organization: Public corporation

Target: N.L Industries

Acquirer: Harold Simmons

Nature and source of expected benefit(s): Restructuring

Acquirer's diversification strategy and record:

Opportunistic raids on a variety of firms including Sea Land (found white knight in CSX), Medford Corp. (successful), Amalgamated sugar (successful), steel, wire and hardware firms.

Commitments made/Plans announced before takeover:

Spin off chemicals unit.

Acquirer/Target Business overlap: None

Acquiring organization: Shell investment company

Target: Frigitronics

Acquirer: Revlon

Nature and source of expected benefit(s): Restructuring

Acquirer's diversification strategy and record:

See takeover of Revlon

Commitments made/ Plans announced before takeover:

Sell artificial lens implant bus. and stake in Medchem to J&J

Acquirer/Target Business overlap: Commonality of retailing skills

Acquiring organization: Closely held public company -- vehicle for Perleman's investments.

Target: Safeway

Acquirer: Dart Group Corp. (Haft family)

Nature and source of expected benefit(s): Restructuring

Acquirer's diversification strategy and record:

Takeover attempts of a number of retailing firms including May Dept. Stores, Jack Eckerd, Revco D.S. Inc., and Beatrice. Started Dart Drugs, Crown Books corp. and Trak Auto corp.

Acquirer/Target Business overlap: None

Analysts comments:

"He [Herbert Haft] is a very young energetic 65 (years old), and would welcome the opportunity to operate the Safeway chain."

Acquiring organization: Closely held firm

Target: Chesebrough Ponds

Acquirer: American Brands

Nature and source of expected benefit(s): Portfolio

Acquirer's diversification strategy and record:

Core business in tobacco; diversified through acquisitions in order to reduce its exposure to tobacco into several businesses including security products and services, golf products, personal care items such as Jergens lotion, food products such as Sunshine crackers, office products such as Swingline and financial service operations such as Franklin Life and Southland Life. Reputedly, "has had the most aggressive and longstanding diversification strategy of the U.S. cigaret companies."

Rationale offered for attempt:

Target "highly compatible" in the area of consumer packaged goods.

Commitments made/ Plans announced before takeover:

Keep target's management.

Acquirer/Target Business overlap: Some commonality of channels

Analysts comments:

Merger would reduce tobacco's contribution to American Brand's profits to around 30% from the current 52%.

Acquiring organization: Diversified public company.

Target: National Gypsum

Acquirer: Wickes Companies

Nature and source of expected benefit(s): Finl./Restr.

Acquirer's diversification strategy and record:

Emerged from Chapt. 11 in 1985 under the control of turnaround specialist, Sigoloff. In order to take advantage of \$500 million of tax loss benefits and to build an attractive portfolio of businesses, Sigoloff embarked upon an extensive program of acquisition and divestiture. Sold general retailing operation for about \$300m; acquired G&W's consumer and industrial products group, Collins & Aikman; made bids for Lear Sigler and OCF.

Commitments made/ Plans announced before takeover:

"Desirous of retaining management."

Acquirer/Target Business overlap: Related industry.

Acquiring organization: Diversified public firm

Target: Sanders Assoc.

Acquirer: Loral Corp.

Nature and source of expected benefit(s): Restructuring

Acquirer's diversification strategy and record:

Limited acquisitions, within defence industry. Acquired Goodyear Aerospace Corp. after bid for Sanders failed.

Rationale offered for attempt:

Sanders and Loral produce complementary products, and "the world is moving towards systems in which jamming and receiving are integrated."

Acquirer/Target Business overlap: Same industry.

Analysts comments:

"Loral and Sanders fit together, like a hand in a glove."

Acquiring organization: Focused public company.

Target: Hammermill Paper

Acquirer: Paul Bilzerian

Nature and source of expected benefit(s): Restructuring

Acquirer's diversification strategy and record:

See Cluett Peabody takeover

Commitments made/ Plans announced before takeover:

Run Hammermill as an ongoing business, keeping the present management team.

Acquirer/Target Business overlap: None

Acquiring organization: Limited Partnership

Target: Fruehauf

Acquirer: Asher Edelman

Nature and source of expected benefit(s): Restructuring

Acquirer's diversification strategy and record:

See Ponderosa takeover.

Acquirer/Target Business overlap: None

Acquiring organization: Limited partnership

Target: Anderson Clayton

Acquirer: Bear Stearns/ Gruss and Co.

Nature and source of expected benefit(s): Restructuring

Acquirer's diversification strategy and record:

Bears Stearns, an investment bank, participated as principal in several LBO deals. Gruss, a family owned firm, owns businesses in the food, agribusiness and energy industries.

Commitments made/ Plans announced before takeover:

Sell Gaines (dog food business) to Quaker Oats for \$240 million and sell other assets for about \$200m.

Acquirer/Target Business overlap: None

Acquiring organization: Limited partnership

Target: Joy Mfg.

Acquirer: Pullman Peabody

Nature and source of expected benefit(s): Port./Restr.

Acquirer's diversification strategy and record:

According to Value Line: "Management has a long track record of finding undervalued companies, selling off unprofitable businesses and rejuvenating the remaining operations. Pullman recently completed a spate of divestitures of the former Peabody International that has made it a much more profitable and financially stronger company.."

Rationale offered for attempt:

Reduce cyclical nature of acquirer's business.

Acquirer/Target Business overlap: None

Acquiring organization: Diversified public company

Target: John Blair

Acquirer: MacFadden Holdings

Nature and source of expected benefit(s): Restructuring

Acquirer's diversification strategy and record:

Several acquisitions in the media and publishing business.

Acquirer/Target Business overlap: None

Acquiring organization: Private firm

Target: Mayflower

Acquirer: Laidlaw Transp.

Nature and source of expected benefit(s): Syn./Restr.

Acquirer's diversification strategy and record:

Growth through acquisitions of many small school bus and solid waste management businesses. Also, some large acquisitions: of GSX, in 1986, and Harmon and Sons in 1984.

Commitments made/ Plans announced before takeover:

Hinted at sale of Mayflower's moving business.

Acquirer/Target Business overlap: Same industry

Acquiring organization: Closely held firm

Target: Avondale Mills

Acquirer: Dominion Textiles

Nature and source of expected benefit(s): Synergistic

Acquirer's diversification strategy and record:

Dominion, the largest Canadian mfg. of textiles and related products accumulated a war chest in 1986 with the intention of making sizable U.S. acquisitions that would double its revenue base. Teamed up with Asher Edelman to make a bid for Burlington Industries, apparently with an eye on taking over its denim operations.

Rationale offered for attempt:

Dominion and Avondale have complementary positions in the denim and yarn business.

Acquirer/Target Business overlap: Same industry.

Acquiring organization: Public Textile firm

Target: Allied Stores

Acquirer: Campeau Corp.

Nature and source of expected benefit(s): Restr/Syn.

Acquirer's diversification strategy and record:

Real estate developer believed that control of retail chains would provide leverage in developing malls by providing anchor tenants. After Allied acquisition, Campeau then acquired Federated Dept. Stores.

Rationale offered for attempt:

Acquisition would produce a substantial income stream, while bolstering Campeau's opportunities in U.S. real estate.

Commitments made/ Plans announced before takeover:

Offered managers 15% stake in company. Planned to sell several assets to pay down takeover debt.

Acquirer/Target Business overlap: Tangentially related industry -- retail chains are a developer's "customers".

Acquiring organization: Closely held firm.

Target: Owens Corning Fiberglass

Acquirer: Wickes Cos.

Nature and source of expected benefit(s): Restructuring/investment

Acquirer's diversification strategy and record:

See National Gypsum takeover.

Rationale offered for attempt:

Fit of Wickes's building materials retailing operation with OCF's roofing businesses.

Acquirer/Target Business overlap: Related industry.

Acquiring organization: Diversified Public Co.

Target: Carter Hawley Hale

Acquirer: Limited/ Edward DeBartolo

Nature and source of expected benefit(s): Restr./Syn.

Acquirer's diversification strategy and record:

DeBartolo: Strategy similar to Campeau Corp (See Allied) -- acquire real estate through acquisitions of public companies. Teamed up with Paul Bilzerian to bid for Allied. Limited: Strategy of growth through acquisition in specialty retailing.

Acquirer/Target Business overlap: CHH a "customer" of DeBartolo business, and Limited's competitor.

Analysts comments:

"Limited's operations -- Limited, Lane Bryant, Lerner, Henri Bendel and Victoria's Secret stores would complement Carter Hawley operations which offer high fashion, more expensive women's apparel... For Mr DeBartolo, Carter Hawley would offer valuable real estate."

Acquiring organization: Partnership

Target: Gillette

Acquirer: Revlon

Nature and source of expected benefit(s): Restr./Syn.

Acquirer's diversification strategy and record:

See Revlon takeover

Acquirer/Target Business overlap: Related industry (consumer goods and toiletries)

Analysts comments:

Revlon would probably divest most of Gillette's assets

Acquiring organization: Public company, used as investment vehicle by Perleman

Friendly Transactions in 1985.

Target: R.C.A.

Acquirer: G.E.

Nature and source of expected benefit(s): Port./Syn

Acquirer's diversification strategy and record:

Reshuffling corporate portfolio. From 1980 to 1984, G.E. sold 120 businesses and bought 50 others. Sales were of mature businesses (e.g. Utah International, small appliances). Acquisitions were of growth businesses in high-tech and services. Acquired Employees Reinsurance Corp. from Texaco, 80% stake in Kidder Peabody and Kerr Leasing. Discussed possible white knight rescue for CBS and bid for Hughes Aircraft. The strategy was apparently to buy stable, "protected" cash generators to help fund investments needed to stay competitive in exposed businesses.

Rationale offered for attempt:

According to Chairman Welch, "you take a powerful (broadcasting) network, a strong defense business, and a billion dollar service company, all relatively invulnerable to imports and they strengthen your domestic base to make you a stronger, more viable exporter".

Commitments made/ Plans announced before takeover:

No changes to be made in the way consumer electronics businesses are run.

Acquirer/Target Business overlap: Both companies operated in consumer and defense electronics, but overlap was limited.

Analysts comments:

Crown jewel in the acquisition of RCA is the NBC network.

Acquiring organization: Diversified public corporation.

Target: ABC

Acquirer: Capital Cities

Nature and source of expected benefit(s): Restr/Syn

Acquirer's diversification strategy and record:

Acquisitions in publishing and entertainment, e.g. Institutional Investor, Cable TV Systems, Sutton Industries (shopping guides). Reputation for picking up cheap properties. According to Value Line, "classic buy 'em and fix 'em outfit...the company is an exceptionally good acquiror. The "proof" of this is not only in the success stories of some Capital Cities purchases like Fairchild Publications; it can also be found in the deals that the company has stayed out of. Management has simply been outbid in a number of acquisitions for major TV stations".

Acquirer/Target Business overlap: Both firms active in TV industry

Acquiring organization: Diversified public company.

Target: Jack Eckerd

Acquirer: Management LBO

Nature and source of expected benefit(s): Def/Restr.

Acquirer's diversification strategy and record:

N.A.

Analysts comments:

"Senior debt repayment schedule requires a rapid reversal of Jack Eckerd's recent lackluster performance in its core drugstore business".

Acquiring organization: Private investment group.

Other: LBO was in response to takeover attempt by the Dart Group.

Target: Gulf Broadcasting

Acquirer: Taft Broadcasting

Nature and source of expected benefit(s): Port./Inv.

Acquirer's diversification strategy and record:

Asset redeployment: transferring company assets from a capital intensive business, characterized by slow growth and low margins to Taft's core business of broadcasting. No evidence of close integration of operations of acquired properties.

Rationale offered for attempt:

"Expand communications operations in the South and Southwest."

Acquirer/Target Business overlap: Same industry

Analysts comments:

Taft is paying for growth potential and industry leverage.

Acquiring organization: Public company

Target: Gulfstream

Acquirer: Chrysler

Nature and source of expected benefit(s): Port./Syn

Acquirer's diversification strategy and record:

Unrelated diversification, perhaps following GM and Ford's example, into aerospace and financial services in order to diversify income base. Jointly investigated a bid with Boeing for Hughes, but decided against it. Acquired BankAmerica Corp's consumer finance unit.

Rationale offered for attempt:

"Partly for diversification and also an attempt to use aerospace technologies in automobiles."

Acquirer/Target Business overlap: None obvious; however, Chrysler expected commonalities of technology to be found in the future.

Acquiring organization: Public company.

Target: SCOA

Acquirer: Thomas H. Lee + Drexel LBO

Nature and source of expected benefit(s): Restructuring/investment

Acquirer's diversification strategy and record:

Share repurchases had increased management's stake from 10% to 15%

Commitments made/ Plans announced before takeover:

Spin off Dry Goods Stores and Shoe Corporation of America. Expand Hill's department store chain.

Acquirer/Target Business overlap: N.A.

Acquiring organization: Private investment group

Target: Hoover Universal

Acquirer: Johnson Controls

Nature and source of expected benefit(s): Def./Syn.

Acquirer's diversification strategy and record:

Unrelated diversification into building automation systems, and batteries

Rationale offered for attempt:

Synergies in plastics technologies.

Acquirer/Target Business overlap: Some technological overlap possible

Analysts comments:

"We have difficulty pinpointing how the merger will benefit the operations of either company in a major way."

Acquiring organization: Public company

Other: Johnson Controls was itself the target of a takeover bid by Posner.

Target: Conwood

Acquirer: Dalfort

Nature and source of expected benefit(s): Finl./Restr.

Acquirer's diversification strategy and record:

The principals of Dalfort -- the Pritzker family -- had made unrelated acquisitions in a variety of out-of-favor business such as Braniff.

Rationale offered for attempt:

Buy a profitable company with strong earnings performance to take advantage of \$400 million in tax benefits.

Commitments made/ Plans announced before takeover:

Expect to operate under current management.

Acquirer/Target Business overlap: None

Acquiring organization: Private investment company

Target: Telepictures

Acquirer: Lorimar

Nature and source of expected benefit(s): Synergistic

Acquirer's diversification strategy and record:

Acquisitions in entertainment industry including Karl Video Corp., Bozell and Jacobs Inc. Attempted acquisition of Multimedia (all in 1985). Bought 9 TV stations in 1986.

Commitments made/ Plans announced before takeover:

Maintain both managements.

Acquirer/Target Business overlap: Same industry

Analysts comments:

"Telepictures is strong in foreign markets, while Lorimar is strong in first rung network and motion pictures".

Acquiring organization: Public company

Target: Communications Industries

Acquirer: Pacific Telesis

Nature and source of expected benefit(s): Portfolio

Acquirer's diversification strategy and record:

Like other BOCs, diversification into non-regulated businesses. Spent \$316 million to buy 5 adjacent cellular phone companies in Ohio and Michigan. Established separately capitalized subsidiary for unregulated businesses.

Acquirer/Target Business overlap: Some with other cellular businesses

Acquiring organization: Public company

Target: Union Trust

Acquirer: Bank of Virginia

Nature and source of expected benefit(s): Synergistic

Acquirer's diversification strategy and record:

Same industry acquisition in Southeastern banking. Acquired/bid for Citizens Trust, NS&T Bancshares of Washington D.C., Security National of Washington D.C. Acquisitions followed industry wide pattern of consolidation in Washington D.C.- Virginia region.

Rationale offered for attempt:

A natural extension of both companies' markets in the very attractive Baltimore-D.C.-Richmond-Norfolk corridor.

Acquirer/Target Business overlap: Same industry.

Analysts comments:

"They paid one of the heaviest premiums for a bank, and it isn't one that is heavily valued by its fundamentals".

Acquiring organization: Public company

Target: Alamito

Acquirer: LBO

Nature and source of expected benefit(s): Restructuring

Acquirer's diversification strategy and record:

N.A.

Acquiring organization: Limited partnership

Target: Scott & Fetzer

Acquirer: Berkshire Hathaway

Nature and source of expected benefit(s): Investment

Acquirer's diversification strategy and record:

Warren Buffet, Chairman of Berkshire, a legendary value investor dedicated to buying cheap assets with "good managers". Holds passive, long-term (5 year +) stakes in several companies including Geico, Washington Post, Capital Cities, etc.

Acquirer/Target Business overlap: None

Acquiring organization: Closely held quasi-investment company

Target: Chilton Corp.

Acquirer: Borg Warner

Nature and source of expected benefit(s): Portfolio

Acquirer's diversification strategy and record:

Fifty major operating units. Redeploying assets to achieve 50:50 income split between manufacturing and service businesses.

Rationale offered for attempt:

Provide a base to expand into information services.

Acquirer/Target Business overlap: None

Acquiring organization: Diversified public company

Target: Farm Home and Savings

Acquirer: Pacific Realty

Nature and source of expected benefit(s): Port./Syn.

Acquirer's diversification strategy and record:

Diversify out of real estate. Unfriendly bid for U.S. Home in '86.

Rationale offered for attempt:

Enter national capital markets.

Acquirer/Target Business overlap: Target could potentially be a source of funds for suitors real estate business.

Target: G.C. Murphy

Acquirer: Ames Dept Stores

Nature and source of expected benefit(s): Syn/Restr.

Acquirer's diversification strategy and record:

Focussed on department stores. Acquire and turn around (by cutting costs and remodelling), often bankrupt, department stores, . Example: Kings Department stores, Neisner Bros.

Commitments made/ Plans announced before takeover:

Sell one third of acquired stores.

Acquirer/Target Business overlap: Same industry.

Acquiring organization: Public company.

Target: First Bankers

Acquirer: First Union Corp.

Nature and source of expected benefit(s): Syn./Port

Acquirer's diversification strategy and record:

Geographic expansion through acquisitions. Attempted takeover of Florida Coast Bank in '84. Acquired Northwestern Financial Corp (a bank holding co.) in March '85, and numerous other banks in '85 and '86.

Rationale offered for attempt:

Expand presence in Florida.

Acquirer/Target Business overlap: Same industry

Acquiring organization: Public company.

Target: Shop and Go.

Acquirer: Circle K Corp.

Nature and source of expected benefit(s): Syn./Restr.

Acquirer's diversification strategy and record:

Rapid growth through acquisition of convenience stores since 1983 including those of Utote M Inc. (960 stores), Little General Stores division of General Host Corp., and 180 stores of National Convenience Stores. Reputedly believed that it costs more to build and stock a store than to buy an existing outlet as well as buy expectations of economies in distribution and marketing. Acquisitions often financed by sale and lease back of properties.

Commitments made/ Plans announced before takeover:

Upgrade and integrate stores with existing organization.

Acquirer/Target Business overlap: Same industry

Acquiring organization: Public company

Target: International Bank of Washington

Acquirer: USILCO

Nature and source of expected benefit(s): Port./Restr.

Acquirer's diversification strategy and record:

Get 50% of growth from acquisitions.

Rationale offered for attempt:

"Gain flexibility for future acquisitions...our book value will go up".

Commitments made/ Plans announced before takeover:

Divest several units of International Bank and reorganize operations.

Acquirer/Target Business overlap: None

Acquiring organization: Holding company

Target: Dyco Petro Corp.

Acquirer: Diversified Energies

Nature and source of expected benefit(s): Portfolio

Acquirer's diversification strategy and record:

Unrelated diversification. New management, installed in 1982, decided to diversify in order to get 25% of earnings from non-regulated businesses taking advantage of regulated subsidiaries' cash flow. Between 1982 and 1986, acquired two small companies that conduct undersea inspections of offshore drilling rigs and Western Union's E.F. Johnson division (a maker of electronic equipment).

Rationale offered for attempt:

Gain 25% of earnings from non-regulated businesses.

Acquirer/Target Business overlap: None

Acquiring organization: Public company

Target: Franklin Corp.

Acquirer: United Jersey Banks

Nature and source of expected benefit(s): Syn./Def

Acquirer's diversification strategy and record:

Expand market share in New Jersey. Failed bid for Heritage Bancorp which had a strong Southern New Jersey presence. After acquisition of Franklin, New Jersey Bancorp acquired Commercial Bancorp for its 53 branches in Northeastern New Jersey.

Rationale offered for attempt:

Acquire 200 offices in 16 of New Jersey's 21 counties.

Acquirer/Target Business overlap: Same industry

Acquiring organization: Public company

Target: Mite Corp.

Acquirer: Emhart

Nature and source of expected benefit(s): Portfolio

Acquirer's diversification strategy and record:

Unrelated diversification. Company operates in four segments - commercial, components, footwear, and industrial. Strong cash flow supports acquisitions in a variety of fields. In 1985, looking for candidates in its four major product segments. After acquisition of Mite, acquired True Temper - a leading manufacturer of lawn and garden tools, and Arcotronics - a European producer of capacitors. As an indication of its high diversification activity, the Wall Street Journal noted that Emhart had bought the PCI Group twice as of December 1986, and was planning to sell it again.

Acquirer/Target Business overlap: Some overlap

Acquiring organization: Diversified public company

Hostile Transactions in 1981

Target: General Portland

Acquirer: Canada Cement Lafarge (LAF)

Nature and source of expected benefit(s): Port./Inv.

Acquirer's diversification strategy and record:

Bought another construction materials company (East Texas Stone) in 1986. Formed holding company to manage cement companies. No evidence that Lafarge made any attempt to significantly influence G.P.'s strategy after acquisition.

Rationale offered for attempt:

Expand in the U.S. in anticipation of construction boom in the mid-1980s.

Commitments made/ Plans announced before takeover:

Maintain G.P. as a distinct sub.

Acquirer/Target Business overlap: Same industry.

Analysts comments:

Not a bargain. Paid 16X earnings and 80% above book when industry stocks were trading at 30% below book.

Acquiring organization: Public Company.

Target: Garfinkel Brooks

Acquirer: Allied Stores

Nature and source of expected benefit(s): Synergistic

Acquirer's diversification strategy and record:

Growth in upscale retailing through acquisitions of Bonwit Teller and Plymouth ('79), Jerry Leonard ('85) and Gimbels ('86). Invest in to upgrade stores acquired.

Rationale offered for attempt:

Acquire well established stores in good markets.

Commitments made/ Plans announced before takeover:

Increase investment.

Acquirer/Target Business overlap: Same industry.

Analysts comments:

"Price looks generous -- paying 14 times earnings - the highest multiple the stock has commanded in 10 years."

Acquiring organization: Public Corporation

Target: Magma Power Co.

Acquirer: Natomas

Nature and source of expected benefit(s): Port/Inv

Acquirer's diversification strategy and record:

Wide ranging interests in petroleum, ocean shipping, real estate and geothermal. Continued strategy of "controlled diversification" (eg. acquisition of Trail Mountain Coal Co.) until it was acquired by Diamond Shamrock.

Rationale offered for attempt:

"Will become a major and growing source of domestic earnings, particularly in the late 80s and 90s" when Natomas's stake in Indonesian oil fields tapers off.

Commitments made/ Plans announced before takeover:

Acquire geothermal assets only; spin off rest of the assets back to the public.

Acquirer/Target Business overlap: NA

Analysts comments:

High price paid: 8 times book and 40 times earnings.

Acquiring organization: Diversified public company

Target: Buffalo Forge

Acquirer: Ampco Pittsburgh

Nature and source of expected benefit(s): Investment

Acquirer's diversification strategy and record:

Diversify out of steel into mature and out of favor areas such as freight car building, air handling equipment, ingot molds and steel rolling equipment eg. Pittsburgh forgings ('80); Vulcan ('84) and Union Electric ('84).

Rationale offered for attempt:

According to the chairman: "Companies with capital assets are a good hedge against inflation. And the best strategy is to buy with borrowed money and repay the debt with cheaper dollars." Also, "previous acquisition of Pittsburgh forgings made company vulnerable in economic downturns. Buffalo Forge should help even out the cyclical swings."

Acquirer/Target Business overlap: None

Analysts comments:

"The smokestack mentality is very real at Ampco Pittsburgh. They want to be a billion dollar company." Mario Gabelli.

Acquiring organization: Public company

Target: Continental

Acquirer: Texas Air

Nature and source of expected benefit(s): Synergistic

Acquirer's diversification strategy and record:

Build low cost national airline through acquisitions followed by renegotiation of wages and work-rules. Acquisitions include: Rocky Mountain Airways, Peoples Express, Frontier, Eastern and Bar Harbor. Also attempted takeover of TWA.

Acquirer/Target Business overlap: Same industry

Acquiring organization: Public company

Target: Fisher Scientific

Acquirer: Whittaker Corp

Nature and source of expected benefit(s): Portfolio

Acquirer's diversification strategy and record:

Unrelated diversification thru' acquisition. Takeovers followed by increased investment in acquired companies. Acquired General Medical in 1980. Attempted to acquire Brunswick's Sherwood Medical division. Acquired CPL corp. ('79), Heico ('79) and Hospital Supply standard's scientific division.

Rationale offered for attempt:

Reduce health care segment's dependence on Saudi contract

Acquirer/Target Business overlap: Only in some businesses

Target: Hobart Corp.

Acquirer: Canadian Pacific Enterprises

Nature and source of expected benefit(s): Portfolio

Acquirer's diversification strategy and record:

Unrelated diversification into steel and metals, oil and gas, railroads, forest products and hotels. Willing to take partial (non-controlling) interests (eg. one-third interest in Dart containerline). Goal of increasing investments in the U.S. to 25% of assets.

Rationale offered for attempt:

"Cheap acquisition".

Acquirer/Target Business overlap: None

Analysts comments:

Stock undervalued because of managers' unwillingness to co-operate with analysts.

Acquiring organization: Holding company for Canadian Pacific's investments.

Target: St. Joe's Minerals

Acquirer: Seagrams

Nature and source of expected benefit(s): Investment

Acquirer's diversification strategy and record:

Bought and sold Texas Pacific Oil Co. for \$1.2b profit. Commissioned consulting study to find suitable targets for investing these funds. Apparently decided to reinvest in the resources sector; after bid on St. Joe's, made a hostile offer for Cononco and eventually settled on a passive stake in DuPont.

Rationale offered for attempt:

"A solid investment opportunity".

Commitments made/ Plans announced before takeover:

Retain management team

Acquiring organization: Public corporation, controlled by Bronfmans; hence could be construed as an investment vehicle for the family.

Target: Conoco Inc.

Acquirer: Seagrams

Nature and source of expected benefit(s): Investment

Acquirer's diversification strategy and record:

See St. Joe's / Seagrams

Acquirer/Target Business overlap: None

Target: Brookwood Health

Acquirer: Humana

Nature and source of expected benefit(s): Synergistic

Acquirer's diversification strategy and record:

Focussed on health care. Numerous acquisitions including American Medicorp ('79) and Emergency Medical Systems. Acquisitions closely integrated into existing businesses. For example, after acquisition of American Medicorp, "mangement acted quickly and effectively to streamline the combined hospital chain, saving \$14m in administrative costs."

Acquirer/Target Business overlap: Same industry

Acquiring organization: Public company

Target: Cenco

Acquirer: National Medical

Nature and source of expected benefit(s): Synergistic

Acquirer's diversification strategy and record:

Focussed on health care; Active acquiror. Acquisitions followed by consolidation to reduce administrative costs. Acquisitions included Hillhaven, Guardian Medical, National Health Enterprises, 66 nursing homes and 21 psychiatric hospitals from First Washington group, and, National Health Enterprises.

Acquirer/Target Business overlap: Same industry

Acquiring organization: Public company

Target: Sunbeam

Acquirer: IC Industries

Nature and source of expected benefit(s): Portfolio/Financial

Acquirer's diversification strategy and record:

Unrelated diversification. Broadly based holding company for Illinois railroad. Subs allowed considerable autonomy. Owns units in soft drinks bottling, auto supplies and food products. Was "redeploying assets" in '81 - the railroad was on the block and acquisitions were being sought. After the failure of the Sunbeam deal, IC industries acquired European chain of auto repair shops, and a privately held specialty food processor.

Acquirer/Target Business overlap: None

Acquiring organization: Holding company

Target: Marathon Oil

Acquirer: Mobil

Nature and source of expected benefit(s): Synergistic

Acquirer's diversification strategy and record:

Had stopped unrelated diversification (eg. Montgomery Ward type acquisitions) to bid for domestic reserves and unexplored acreage; e.g. Conoco ('81), Vickers ('80), TransOcean ('80). Doubled unexplored lease inventory from '79 to '81. Track record: intensive exploration of acreage; 30 percent of capital budget devoted to U.S.

Commitments made/ Plans announced before takeover:

Sell refining and marketing operations to Hess.

Acquirer/Target Business overlap: Same industry

Analysts comments:

"Shares of Marathon selling at steep discounts to underlying assets"

Acquiring organization: Public company.

Target: Hobart Corp.

Acquirer: Dart and Kraft (white knight)

Nature and source of expected benefit(s): Portfolio

Acquirer's diversification strategy and record:

Unrelated diversification. Act as "umbrella company over many separate businesses". Acquisitions sought in any business, as long as they produced products of "a unique nature". Recent acquisitions include: Celestial Seasonings (1984); Frusen (1985) and Vulcan Hart (1986)

Acquirer/Target Business overlap: None

Acquiring organization: Diversified public company

Target: St. Joe's Minerals

Acquirer: Fluor (white knight)

Nature and source of expected benefit(s): Portfolio

Acquirer's diversification strategy and record:

Seeking a capital intensive, resource based partner to invest Fluor's cash flow. Willing to make passive investments (eg. 50% interest in Massey Coal).

Rationale offered for attempt:

According to the chairman, minerals "are about as inflation proof as you can get...That's precisely the reason" why Fluor's directors chose to acquire natural resources.

Commitments made/ Plans announced before takeover:

"St. Joe's management will stay intact."

Acquirer/Target Business overlap: Fluor supplier to St. Joe's.

Acquiring organization: Public company

Target: Conoco Inc.

Acquirer: Du Pont (white knight)

Nature and source of expected benefit(s): Portfolio

Acquirer's diversification strategy and record:

Focussed on chemicals. Few acquisitions before or after. Joint venture with Conoco before acquisition to develop reserves.

Commitments made/ Plans announced before takeover:

Operate as separate sub.

Acquirer/Target Business overlap: Low

Analysts comments:

Chemical industry margins decline when oil prices rise. Acquiring Conoco protects parent from rising oil prices.

Acquiring organization: Public company.

Target: Brookwood Health

Acquirer: American Medical International (white knight)

Nature and source of expected benefit(s): Synergistic

Acquirer's diversification strategy and record:

Same industry expansion through acquisitions. Integrate acquired businesses with existing businesses to reduce costs. Acquired Hyatt Medical Enterprises; numerous individual hospitals; and, Lifemark. After 1985, embarked on acquisitions outside the health care arena.

Acquirer/Target Business overlap: Same industry

Analysts comments:

"Hefty price tag."

Acquiring organization: Public company.

Target: Cenco Inc

Acquirer: Manor Care (white knight)

Nature and source of expected benefit(s): Synergistic

Acquirer's diversification strategy and record:

Diversified into health care and hotels. Growth mainly through acquisitions. Integrate acquisitions to gain cost efficiencies; upgrade percentage of paying patients to raise margins; and, sell off non health care components of acquired companies. Acquisitions include Quality Inns, Leader health care, and Anta Corporation's Four Seasons nursing centers.

Acquirer/Target Business overlap: Same industry.

Analysts comments:

Paid a high premium.

Acquiring organization: Public company.

Target: Sunbeam Corp.

Acquirer: Allegheny Intl.(white knight)

Nature and source of expected benefit(s): Portfolio

Acquirer's diversification strategy and record:

Unrelated diversification. In early 80s, AI, was restructuring its portfolio away from cyclical steel and into consumer products, exotic metals and industrial prods. For example, Allegheny acquired Wilkinson Match ('80), interest in TransGlobal Films ('80), and bid for the carbon dioxide business of Liquid Air Corp. and Scripto.

Rationale offered for attempt:

"Fit with Allegheny's international marketing network".

Acquirer/Target Business overlap: None

Acquiring organization: Diversified public company.

Target: Marathon

Acquirer: U.S. Steel (white knight)

Nature and source of expected benefit(s): Portfolio

Acquirer's diversification strategy and record:

Diversify out of declining steel business. Bought Husky Oil, ECOL (convenience-service station chain) and Texas Oil and Gas. Adopted holding company structure to give company "greater flexibility to diversify into new businesses that are more profitable than steel".

Commitments made/ Plans announced before takeover:

Maintain Marathon as a separate sub.

Acquirer/Target Business overlap: None

Acquiring organization: Public company

Target: Fisher Scientific

Acquirer: Allied Corp. (white knight)

Nature and source of expected benefit(s): Portfolio

Acquirer's diversification strategy and record:

Unrelated diversification in a wide variety of industries. Acquired Eltra Corp ('79), Bunker Ramo ('81), Apollo Lasers, HB Electrical Mfg. Co., Bendix and Signal Corp.

Rationale offered for attempt:

"Major new core business in scientific health care products."

Acquirer/Target Business overlap: None - perceived as launching pad into new sector.

Acquiring organization: Diversified public company

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