Hostile Takeovers

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IT IS INNOVATION AND change that have created 35 million new jobs in the US since 1965. During that time the largest companies among the Fortune 500 have shed three million jobs, whereas small and medium-sized enterprises have created most of the new jobs, especially those companies guided by innovation and driven by entrepreneurial spirit.

Mature businesses contract for a number of reasons, some good and some bad.

Chief among them are:

- They often operate in mature industries, which means that the bulk of their investment goes into improving productivity rather than creating growth.

- New enterprise is created by innovators. As it matures bureaucracies often develop. Sometimes the bureaucracy inherits management control. Bureaucracies tend to administer rather than to create. Therefore the propulsive life force of the enterprise diminishes and consequently so does innovation and growth.

- It is rare but not impossible to find a creative conglomerate. Very often, however, conglomerates were created for accountancy purposes. Profits and growth were maintained by further and larger acquisitions which can provide the outward appearance of healthy growth. And to increase short-term profitability, items with a long payout, such as research and development, would be curtailed, thereby flattering immediate profits and reducing longer-term organic growth.

All this does not matter in a free economy. As in nature the old and mature retire and die. They are replaced by the young and new.

In a free economy the inefficient are eliminated and the efficient - as long as they remain so - grow for the benefit of all.

But this process is sometimes complicated by the intervention of a number of powerful forces which have a vested interest in resisting change.

For example, labor unions, in the name of saving jobs, seek protection for companies that are failing to compete. In fact this protection usually protects no more than the inefficiencies which crippled those companies in the first place.

Britain provides the best case in point. Resistance to change and protection of inefficiencies with the avowed aim of saving jobs has resulted in the almost total destruction of many British industries, including shipbuilding, the docks, automobile manufacturing, and others.

But there is another equally powerful force against change - the corporate bureaucracies. They constitute a powerful lobby because they are the establishment. They also control huge corporate funds.

Like all establishments they feel that they have a natural right to survive no matter what their performance. What is more, they feel that anyone who threatens that right is an impudent upstart.

It is true that the upstarts in question are acting in pursuit of personal financial gain and not out of altruism. Very often ambitious upstarts are disagreeable and not very graceful people.

That is irrelevant. The question is not whether established corporate bureaucracies are populated by nicer people but whether taken as a whole it is better to allow freedom for change or to erect protective barriers against it.

That is the crux of the argument about hostile takeovers and the consequent panoply of shark repellents.

The questions that need to be analyzed and answered are:

- Why are some companies vulnerable to hostile takeovers?

- What are the consequences when a company is taken over and particularly what are the consequences if it is broken up?

- What are the responsibilities and relative rights of management and shareholders prior to or during a hostile takeover? To succeed on a sustained basis, a corporation must sell the right products and services, of the right quality and at the right price. The judge of what is right is the market place.

Management can only achieve this if, at every level in the corporation, it employs people of the appropriate quality. And it will only attract and retain such people if it creates a satisfying working environment including motivation, incentives and rewards.

If management fails in its tasks, then the stock-market value of the shares of the corporation for which it works will fall. That corporation will then be vulnerable to a hostile takeover.

Another cause of vulnerability is when a company adopts a structure which does not allow its true fundamental worth to be reflected in its share price.

The best example is the conglomerate. Some conglomerates succeed in retaining management excellence but they are rare. Usually the organic growth and profitability of a conglomerate's constituent parts do not compare favorably with those of single-industry companies.

When this is the case, the conglomerate is vulnerable to takeover, and to a break-up. The acquirer would sell off most pieces and retain the division with which he feels comfortable. The vulnerability to a hostile takeover is caused by the fact that the sum value of the pieces of the conglomerate is greater than the value attributed by the stock market to the whole. Another type of company which is vulnerable to takeover is a company with a major asset whose value is not reflected in the market price of its shares. Such companies, can be found in the forest products industry; they sometimes own large and valuable timber lands, which were acquired many decades ago and which appear in their balance sheets at historically low prices.

Management find this attractive because they can cut timber and use this raw material, while valuing it at its historic low book value. This flatters the company's operating accounts. Obviously it would be more difficult to operate at a profit if these managements had to buy their raw materials in a free market place and at a fair price.

No doubt H.J. Heinz would declare a greater operating profit from the manufacture of ketchup if it did not have to charge itself with the cost of tomatoes. So some companies do not appreciate the idea of liberating these valuable assets for the benefit of shareholders. Nonetheless they complain of the unfairness of their vulnerability to hostile takeovers. Of course I am aware of the traditional counter-argument to the points that I have raised. Management will say that they are managing for the long term and that shareholders and the stock market are unable to take into account the future benefits of current endeavors. That is obvious nonsense. The market place is well capable of assessing and attributing a value to future prospects. The proof is the extremely high price-earnings multiple on shares of companies in whose future the market place believes.

It is up to management to explain the facts to their shareholders and to the market.

In recent years a number of conglomerates have been broken up. An analysis of these show that there are several ways in which the subsidiaries or divisions have been deployed:

- Efficient, growing divisions have become independent companies and their shares have been issued on the stock markets.

- Some divisions have been sold to management in leveraged buyouts or through Employee Stock Ownership Plans.

- Some divisions in need of stronger management have been sold to growing single-industry companies which can supply the know-how and the leadership.

On the whole those companies have benefited by their liberation from the control of a tired conglomerate. On the other hand, a number of the corporate head-office bureaucrats have often lost their jobs.

The conclusion that can be drawn is that various operating entities have been invigorated and shareholders have benefited by receiving a much higher price for their shares. Only the corporate bureaucracies have suffered - albeit with significant golden parachutes and other compensation packages.

The solution to the problems posed by hostile takeovers and the panoply of consequent shark-repellents is relatively straightforward.

First it must be remembered that shareholders are the owners, and that management are employed by them to manage an enterprise on their behalf.

If management feel that it is in the best interest of shareholders to introduce shark repellents into the company's articles of association, then they should explain their reasoning to shareholders; then the shareholders, the owners of the company, should vote on the resolutions.

If to fight off an unwelcome approach management want to buy back blocks of shares at a premium over the market price, then they should explain this to shareholders and submit the proposal to a vote by them.

Similarly, if management wish to embark on what has become known as a policy of scorched earth by selling off valuable assets or making defensive acquisitions, here again, the proposals should be explained and submitted for a vote by shareholders.

It seems wrong that members of management, to entrench themselves, should scorch earth. After all, the earth being scorched belongs not to management but to shareholders.

If management refuse to explain their case to shareholders and submit it to a free vote, then the conclusion is inescapable: Management are acting for their own survival and are reneging on their contract to protect the interests of those who have entrusted them with the responsibility - the shareholders.

On the other hand, shareholders would be wise to take steps to eliminate such conflicts of interest. The most effective way is to align the interests of management with their own by appropriate stock-incentive schemes. Management would then be delighted to obtain the best price for their shareholders, as they also would benefit handsomely.

Although this seems obvious, it is nonetheless the subject of controversy. The reason is that an unfortunate aspect of bureaucracies is that they tend to become worlds of their own, detached from the realities of the marketplace.

Sometimes they begin to believe that the business that employs them has become an institution which is their property. Shareholders then become no more than an inconvenience. Some managements begin to believe and to state publicly that shareholders lack the wisdom to vote. They have even gone so far as unilaterally to deprive their shareholders, without consulting them, of certain of their basic rights.

Students of history will know of governments that have believed that their voters lacked the wisdom needed to vote, and therefore have taken over that responsibility on their behalf.