Statement made to the International Mergers & Acquisitions Conference

16th November 1989

NOT ALL MERGERS and takeovers are good, nor are they all bad. Not all leverage is imprudent, nor is it all prudent. Only the foolish or the intellectually dishonest will fail to distinguish between one category and the other.

The trouble is that excesses lead to reactions and reactions can overshoot. This can result in bringing about fundamental change which is neither intended nor desirable.

My purpose, this morning, is to try to distinguish between good and bad takeovers, and between different categories of leverage; also I will suggest some lessons to be learned from recent developments in the USA where the takeover cycle is more mature; finally, I will attempt to propose a solution to some of the problems as I see them.

Mergers and takeovers occur for a number of reasons.

Here are four typical examples:

- In some industries, it is necessary to sell products internationally. So there are transnational mergers to supply the infrastructure.

- Or large research budgets are needed. So there are mergers for size within the same industry.

- Or there can be an advantage in extending a company's product range into a closely allied or genuinely complementary activity. So another company is acquired to provide special skills and market position.

- Or, finally, a large company might wish to acquire a particularly innovative smaller company within its own industry. The desired objective is for the larger company to benefit from an injection of creative vigour and for the small company to benefit from an injection of capital.

Those are all good reasons for a merger and few, today, would disagree. Yet, in the 1950s and 1960s, many were prohibited on the grounds that they were considered anticompetitive. This was to have considerable impact on the future.

The mistake was to treat all industries as though they were identical. Standards for competition should be quite different for an industry which competes worldwide as opposed to one whose marketplace is local. In the retail trade, concentration of ownership in anyone place will be anti-competitive and will lead to high prices, poor service and general decadence. But, in many manufacturing industries, the marketplace is global and competition should be judged accordingly.

A good example of an ill judged intervention was the complaint by the anti-trust division of the US Department of Justice in 1968 prohibiting Gillette from acquiring the German electric razor company, Braun. That merger seemed to satisfy most of the criteria that I described earlier and yet was prohibited on the grounds that it was anti-competitive. This policy was a significant contributing factor to the emergence of another category of acquisition - the conglomerate merger. Nature's empire builders, finding themselves prohibited from expanding by acquisition within their own industries, embraced diversification and created conglomerates. The stock-markets were enthusiastic and placed high ratings on their shares. This accelerated the movement because conglomerates could issue their shares as currency for acquiring other companies and as their shares were valued at higher price/earnings ratios, each acquisition furthered the impression of rapid growth of earnings per share. So the conglomerates were able to enter into a buying frenzy.

Twenty years later, it was possible to assess objectively the performance of these multi-industry groupings. Taken as a whole, with some notable exceptions, the conglomerates had failed. When comparing divisions within a conglomerate to stand-alone and focused companies in similar industries, the conclusions were clear. The conglomerates, in general, had underperformed in growth, profitability, worthwhile capital investment, creation of employment and innovation.

During this period, many of the original conglomerators had retired or died and had been replaced by professional management. The term 'professional management' usually means management that did not found and does not own a significant share of the company. Some such management was very good. They understood the need to deconglomerate and to concentrate their efforts on their core business, that is to say the business which they know best and believe in most. Gulf and Western, now Paramount, is an example. Others were not so good. Their arrival merely replaced the flame of the founder by the complacency of the bureaucrat. That did little for the business except to make it more respectable. As they became large, passive and ceased to pose a threat, conglomerates joined the establishment.

This attracted a new and wholly different group of conglomerators. They were the corporate management of major companies which produced very large cashflow from cash rich, low growth or slowly declining industries. They faced the choice of disbursing this cashflow to their shareholders who could invest it as they thought fit or, alternatively, retaining it and investing in new businesses. It is a temptation to chose the latter because there is a structural conflict of interest between shareholders and professional management. Shareholders want value. They want to see the fundamental value of their shares rise and, ultimately, be reflected in the market price. Management, without a stake in the business, has a natural tendency to prefer size. The bigger the business it runs, the greater its prestige, rewards and power of patronage. Nonetheless, some who chose the second course, acted wisely and invested in businesses which were allied to their core business and which could benefit from existing infrastructure and skills. Philip Morris is the outstanding example. Others joined the rush to conglomerate and did so long after most thinking people could see quite clearly that the conglomerate structure had failed. Paying large premiums over market, they acquired companies with no connection whatsoever with their traditional businesses, about which they had no knowledge and for which they had neither the management skills nor the corporate culture. They also failed.

A fundamental question is how to cope with a large company that is failing. Of course, I do not mean just conglomerates, but any large company. It is not easy to identify such companies before it is too late. Large companies do not suddenly go bankrupt. They are rich and by selling off residual assets, can finance their decline for long periods of time. Or they might have one division that produces substantial cashflow which can be diverted to irrigate the failing diversifications.

Usually, the management is serious and honourable, so they administer decline seriously and honourably. Often they give up just before ultimate failure and if there is still some flesh on the carcass, they disappear into a friendly company. Nonetheless, the damage will have been done.

In the UK, over the past decades, we have witnessed the demise, in this way, of large parts of entire industries such as motorcars, motorcycles, electrical products, machine tools, shipbuilding etc ...

A good example in the US is Pan Am. Once a great company, it lost its way. Its steep decline was financed by the sale of such valuable assets as Intercontinental Hotels and the Pan Am Building. The proceeds of these disposals allowed management to continue without tackling the underlying problems. The independent directors failed to provoke remedial action. Shareholders voted with their feet - they sold and moved along. When things became desperate, the unions attempted to find a buyer for the company who would be willing to make the necessary changes. Some changes have now taken place and hopefully these will have come in time.

Many different solutions are canvassed. In centralised systems of government, it is thought that the State should intervene. Experience in Eastern Europe, Latin America and elsewhere has now turned this into a minority view.

Some wonder whether the Japanese model might be applicable to us. It certainly seems to work for them. But it is a wholly different system based on a particular form of collective capitalism. It did not spring up overnight as a result of a management decision or a piece of government legislation. It has emerged from a culture which for the past four hundred years has taught its people to consider sociopolitical loyalty as the supreme virtue. In any case, the Japanese see their situation as being very different to ours. In their eyes, we suffer from what they call ‘advanced nation disease.’

In Britain, some suggest that the large commercial banks, the clearers, should, as in Germany, assume a dominant role. But in the UK, the commercial banks have, at best, an uneven record in running their own businesses.

Obviously, institutional shareholders have an important role to play and should be active investors. But, perhaps, they are right to play that role as a substantial factor in the marketplace rather than attempt to assume direct responsibility for British industry.

The marketplace is relatively efficient but it, also, can get overexcited. However, it does have the great advantage of being able to correct its mistakes, that is if it is left free to do so. The market is often accused of short termism. But, in fact, companies with convincing long term plans for investment and research benefit from far higher price earnings multiples than do those whose longer term future seems dull. The market is willing and able to value innovation and long term prospects. And, in any case, there seems to be some confusion in the minds of critics between long termism on the one hand and on the other, perhaps unconsciously, remaning long term investors in a stagnating company. Also let me make it clear that the role of takeovers through the marketplace should not be to change satisfactory companies. It is to improve unsatisfactory companies and to allow healthy companies to grow strategically by acquisitions.

This leads me to the great takeover wave of the 1980s in the US It was triggered by a number of factors.

By 1982, investors were despondent, the market was very low and in the eyes of those who could believe in economic revival, the market price of shares in no way reflected the values of underlying businesses. Then there were the great opportumties offered by the failed conglomerates - the debris of the 1960s. They were performing badly and were wholly out of favour.

So a few individuals who believed in economic recovery put up equity capital, borrowed from the banks, and acquired companies either on an agreed basis or through hostile takeovers.

As this is the first time I have used the term 'hostile', perhaps I should attempt to define it within the context of such takeovers. Hostile to whom? Not to shareholders. They were offered a large premium for shares in a declining business and they could reinvest their cash elsewhere. Not to the employees of the underlying businesses. They were suffering from the conglomerate structure. Deconglomeration would lead their business to renewed independence or alternatively to joining a group which could help their future development. Not to suppliers, customers or local communities, and not to the economy as a whole, because the dismantling of a faulty structure leads to positive improvement and a more productive deployment of resources. So, in reality, hostile in this context means hostile to head office staff. As Professor Robert Clark, Dean of Harvard Law School, says, and I quote, 'takeovers via stock ownership are the most effective form of corporate accountability.'

The normal pattern following acquisitions was to sell off the diversified assets, substantially repay the bank debt and retain the core business. The ongoing business would remain with debt at a reasonable level relative to equity. As management concentrated on the core business, and as the economy did, in fact, recover, the result was success. There was also an indirect benefit. Some other conglomerates, with lively management, noted the results and decided, on their own, to repair their faulty architecture.

But then a terrible thing happened. It all became fashionable. There was a rush to follow. Special takeovers funds were created by managers who received large upfront fees plus overrides typically of 20%. Investors, mainly institutional, flocked to put up their money. The typical structure adopted by these funds was to maximise leverage and minimise equity. In this way, profits which might be quite modest relative to the overall transaction, became immense when compared to the minor element of equity. If you acquire a company for one million dollars and make it worth 1.1 million dollars, the profit is 100,000 dollars or 10% of the equity invested. But, if you finance the acquisition with 100,000 dollars of equity and 900,000 dollars of non-recourse debt, the same profit becomes 100% on the equity invested. The same is of course true of losses. The early performance of the funds was spectacular and this attracted more capital.

But all this changed the nature of acquisitions. The sheer weight of money was one change. Huge amounts of equity deployed within a policy of maximum leverage, created a pool of resources that swamped the available opportunities. For everyone billion dollars of equity invested in the funds there were a further nine billion available in the form of various kinds of debt. Another change was that the transactions became fee driven. Of course, some of the fund managers acted responsibly and did very well for the companies that they acquired and for their investors. But others were too keen to do deals at any price. In a normal acquisition, if the buyer pays too much he suffers. In these transactions, the higher the price, the higher the upfront fees. So prices of businesses soared.

Another change was the nature of leverage. In the early acquisitions, high leverage was a transitory phenomenon. Debt was paid down rapidly from the proceeds of the disposals of the diversified assets. The ongoing core businesses were well capitalised and assumed traditional levels of debt. But in the new transactions which sought maximum leverage, the policy was that even the ongoing core businesses remained thinly capitalised and heavily leveraged. Debt repayment was to be made out of operating cashflow expected over quite a long number of years.

This was leverage of a different kind.

And there was another less noticeable change. Institutions who participated in these acquisition funds, did not wish to become involved in the controversy of hostile bids. So a precondition was that the acquisitions would be friendly. But sometimes this presented a structural problem. As we have seen, the best candidates for such acquisitions are failing companies and the most usual cause of failure is inadequate management. Following a hostile takeover, management is changed. In friendly deals, the old management is consolidated. In the worst, somewhat caricatural cases, the result is a company bought at too high a price, over-leveraged and under-capitalised and managed by a team with a proven record of failure.

So there were excesses not just by the funds but by everybody caught up in the mood. The immediate macroeconomic effects of the mistakes should not be too great, that is unless companies in trouble are destroyed by extended and abusive litigation. Generally speaking, there are three constituencies which can be affected. The lending banks, the holders of mezzanine finance or junk bonds as they are called, and the equity investors. It should be remembered that most of the LBO's will be all right. Of course, there will be some very high profile accidents which will create the impression of generalised disaster. But, in fact, we are looking at a minority of LBO's which will become deeply troubled. In most of the these, the banks are the senior lenders and are reasonably well secured. The mezzanine debt was always a hybrid between debt and capital. If things go well, it is confirmed as being debt and is repaid. If things go badly, effectively it is converted into capital. That is no tragedy because if you look at the problem in macroeconomic terms, the institutional shareholders, as a whole, sold their shares at a good premium and it is the institutions, as a whole, who reinvested part of the proceeds in mezzanine finance. So, they will get back some of their original equity investment in the form of mezzanine finance converted into equity. As for those who invested in the equity capital of LBO's which get into trouble they will lose their investment but that is a normal risk for equity capital.

As I said at Merryl Lynch's Institutional Investors Conference in New York in 1987, failed LBO's will offer great new opportunities for entrepreneurs who will provide new capital and management to re-establish the troubled companies.

Anyhow, the reaction following the excesses led to new attitudes in the law courts, the state legislature and Congress. First, the tax laws were changed and a buyer could no longer step up the tax basis of the assets being acquired to his cost price. So the buyer's cost was deemed for tax purposes to be the historic cost originally paid for the underlying assets by the previous parent company. This legislation was introduced specifically to inhibit takeovers and like all tactical legislation had unexpected ripple effects. Let us take as an example a rich, old conglomerate which has just been acquired. It has become highly leveraged. The debt was to have been repaid by the disposal of diversified assets. But because these assets have been owned for a long time, they are in the books at a very low historic figure and their disposal would result in a high tax charge.

So instead of disposing of the diversified subsidiaries, those subsidiaries are retained and are leveraged at the maximum level, and without recourse to the parent. The cash is extracted in a tax effective way. The result is appalling. Instead of having a rich, tired old conglomerate, you have the same conglomerate, as diversified as before, but instead of being rich, each of its subsidiaries is leveraged to the maximum. So you end up with a conglomerate with a lot of hollow legs.

Then the Courts approved a panoply of poison pills. These transformed the relationship between shareholders and management. Let me give you two examples. The first concerns Polaroid. In September 1988, Shamrock, a company controlled by Roy Disney, made an all cash offer for all the shares of Polaroid. The following was Polaroid management's defence:

(1) Without consulting its shareholders, Polaroid issued new shares representing nearly 14% of its capital to its Employee Stock Ownership Plan, known as an ESOP. To provide the ESOP with funds to pay for these new shares, Polaroid contributed 15 million dollars and made a loan of 285 million dollars, thereby using 300 million dollars of shareholder's funds.

(2) Again without consulting its shareholders, Polaroid issued a further 300 million dollars of voting, convertible, preferred stock and warrants, principally to a friendly investment fund. Polaroid committed to redeem the preferred stock at a premium.

(3) Without consulting its shareholders, Polaroid management used the funds received from the ESOP and from the friendly fund to shrink its capital by way of a self tender and open market repurchases.

As a result of these three transactions, designees of Polaroid's management obtained the right to over one third of the total votes, without ever consulting the shareholders. The US Courts approved the transactions.

The other case concerns the acquisition by Time Inc. of Warner Communications.

Time and Warner were to merge their businesses in a share for share exchange. Then, a third party, Paramount, intervened with a cash bid for all the shares of Time at a price very substantially above the market price. Time management, which already had a poison pill in place, responded by bidding in cash for control of Warner, thereby frustrating Paramount's bid. Time shareholders were not consulted. Paramount and other Time shareholders sued on the basis that Time shareholders were being denied the right to consider the Paramount offer.

The Court found, and I quote: 'The Corporation Law does not operate on the theory that directors, in exercising their powers to manage their firm, are obligated to follow the wishes of a majority of shares. In fact, directors, not shareholders, are charged with the duty to manage their firm'.

I do not wish to express any view on the fundamental merits, or otherwise, of the proposed transactions between Shamrock and Polaroid or Time, Warner and Paramount. I do not know the facts. What I believe to be deeply significant is a legal evolution which quite clearly, quite specifically, transfers the right to corporate governance from shareholders to management. Whether desirable or not, this constitutes a fundamental change with pervasive social, political and economic impact. It deserves a full debate and should not come about just as part of ad hoc defence tactics invented to fight contested takeover bids. As I have referred to the US experience and as today's event is organised by an American newspaper and the leading US lawyers, I will venture some specific ideas which might be applicable to the US and which could also have some relevance to the European business arena.

(1) Tax

The tax structure should allow corporate restructuring to take place in a tax neutral way. Obviously, it is to everybody's benefit that assets be deployed as productively as possible and this should be encouraged not taxed. Higher tax will flow through as a result of improved activity and profitability. Also there should be an even playing field. Corporate restructuring should be as straightforward and tax effective for the company itself to carry out as for a new owner.

(2) Leverage

Probably there should be a concept of thin capitalisation. By this, I mean that when debt relative to capital rises beyond the point of being reasonable, such point should be clearly defined, then for tax purposes, the excessive debt should be treated like capital and taxation should be assessed accordingly. This would eliminate the tax advantages of excessive leverage. But as positive asset redeployment is favourable, it should not be penalised. So there should probably be a period of grace, of say one or two years, during which high leverage would be acceptable pending the disposal of surplus assets and the consequent reduction of the debt. This would not penalise the bridging debt incurred for a short period during which the company is restructured and refocused. But it would discourage chronic hyper leverage.

(3) Poison Pills

Poison pills should be legal for so long as they are all specifically approved by shareholders. Voting should be by secret ballot. This is important because professional investment managers are a large and growing part of the market. They manage, inter alia, corporate pension funds. Over the past few years, despite its fiduciary responsibilities, management of the large companies has threatened to boycott investment managers who have not voted in favour of management entrenchment. Furthermore, a single vote on a single occasion should not be eternally binding. Management should not be entrenched for ever. In business, life tenure is seldom healthy. There should be regular voting on entrenchment issues, at least every three years. This would force managers, who want special protection from free market forces, to explain and convince their shareholders that their purpose is worthwhile.

(4) Relationship between shareholders and management

It should be clearly reaffirmed that corporations are owned by shareholders and that management is employed by shareholders to manage the business on their behalf. But shareholders would be wise to eliminate the conflict of interest that separates them from management. Management should be seeking value not size, excellence not empire. The best way to achieve this is to convert professional managers into owners, to make them partners and to do so by programmes which allow them to acquire shares or options as they reach certain targets and prove their true worth.

(5) Federal versus State legislation

Federal legislation is needed to define the rights and duties of shareholders and management, and this cannot reasonably be left to the State legislators. They are in the business of competing for the favours of corporations. The location of head offices, new factories and other investments is decided by corporate management and not by shareholders. So when corporate management asks for protection from its shareholders or threatens to leave a particular State if that protection is not delivered, the State legislators naturally listen. That is why 29 States already have adopted anti-takeover laws to help entrench management. These new State laws seem to be obtaining approval from the Courts. On the other hand the recently retired Chairman of the SEC, David S. Ruder, said in a speech last year referring to one of the State laws, I quote, 'The Indiana statute is misguided. By failing to consider the shareholder as paramount, the statute removes accountability for corporate management ... '.

In due course, rules will have to be added to the Williams Act. Unfortunately, at the moment, in the present atmosphere in Washington, it is unlikely that any changes would be constructive.

The restructuring and revitalisation of traditional industry about which I have spoken today is important. But, in a rapidly changing world, experiencing the greatest ever industrial revolution, sometimes known as the 'Quantum Revolution', it is even more vital to recognise, pursue and capitalise on new opportunities. That is another subject for another day but it also requires economic freedom.