Assessing the Long-Term Impact of Hostile Takeovers

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Abstract

This paper has attempted to review the hostile takeover phenomenon by casting the arguments for and against such takeovers in an objective framework. The paper also relies on empirical data on the long term impact of hostile takeovers gathered from firms that were taken over successfully. The authors have concluded that the hostile takeover phenomenon is minuscule in terms of the larger merger and acquisitions activity, and that it has beneficial consequences even though the loss of jobs is inevitably painful.

Introduction

Even the most cursory review of American business history will reveal that each decade has been characterized by a set of major upheavals or events that have turned the business world upside down. Takeovers represent the focal event for the eighties. The short-term and most visible impact of takeovers has been severe in terms of the human factor, i.e., loss of thousands of jobs and the negative impact on communities due to plant-closings. While statistics on this vary, the impact definitely has been quite traumatic. The ironic part is that those who are losing their jobs are often paying dearly for the previous acts of inept management.

Beyond this factor, however, there has been an elaborate web of self-serving arguments woven that portray takeovers as a battle between those who are champions of long-term profits versus those who are driven solely by short-term gain. For example, Patrick Lucey, former Wisconsin governor and currently a member of the coalition to Stop the Raid on America, said "Hostile takeovers have significant negative effects on the target corporations, their employees, their families and the local and state economies... Corporate managers have been forced to engage in a well-documented shift towards short-term

perspectives, thereby harming the economy." (PR Newswire, 1988))

Our purpose initially was to assess empirically the long-term impact of hostile takeovers. Sir James Goldsmith's offensive against Goodyear had seemingly served as a rallying point for those who saw hostile takeovers as a threat to the very sovereignty of U.S. business. The intensity of the debate surrounding this particular takeover attempt sparked our interest in the issue of hostile takeovers. Once we began gathering our conceptual information and empirical data it became evident that hostile takeovers constituted a minuscule proportion of the total number of mergers and acquisitions. Also, it seemed to us that the debate on the productivity or destructiveness of takeovers seemed to be based on static economic assumptions, and a selective presentation of information.

Fundamental Facts About Takeovers

Takeovers imply differing levels of resistance on the part of target firms with hostile takeovers representing the most enduring level of resistance offered. According to Harshbarger (1987): "When the conditions of an acquisition are

resisted by the shareholders and/or management of the company being acquired, it is referred to as a takeover, often as a hostile one. When the conditions are more friendly, it is simply called an acquisition."

There has been a continuous increase in the number and dollar value of takeovers and acquisitions. According to Mergers & Acquisitions Almanac, (1988), in 1980 there were 1,565 corporate acquisitions with a transaction price of \$1 million or more. The monetary value of these deals totaled \$33 billion. By 1986 the figures roared to a total of 3,356 acquisitions with a value of \$176.6 billion! (See Table No. 1). Clearly, American business is in the midst of a massive restructuring and redistribution of resources.

It is generally agreed that the following factors have led to an increase in takeovers. First, the tax laws and favorable interest rates have made the addition of debt to the balance sheet an attractive proposition. Leveraging of debt-acquisition happens to be the principal means for funding takeovers. Accelerated depreciation rates have allowed companies to generate attractive cash flows which in turn allows them to service debt more easily. This increase in cash flows did not, of course, get reflected in reported earnings, and thereby in the stock prices. The takeover artists profited from this discrepancy in perceived value and book value. Second, this discrepancy also emerged as a result of the fierce global competition that has made

several domestic companies vulnerable in terms of having under-utilized assets.

Third, the lure of high profits has made large amounts of funds available to fuel such activity. These funds usually come from cash-rich institutional investors or through debt financing from banks. A whole pantheon of takeover artists, backed by millions of dollars in "junk bonds" and cash, has emerged. They include such names as Carl Icahn, T. Boone Pickens, Irwin Jacobs, Asher Edelman, and Saul Steinberg. Wall Street has shown a great deal of innovativeness in developing financial instruments and in structuring financial deals to promote takeovers. Finally, the political environment under the Reagan administration was characterized by a laissez-faire philosophy that encouraged large scale and unprecedented consolidations within industries. The Bush administration may continue this political philosophy if its actions with regard to the Eastern Airlines strike are any indication.

According to the Wall Street Journal (7/28/88) more and more states are either considering, or have already passed, legislation to discourage or temper the pace of takeover activity. The passage of a bill by congress requiring employers to give 60 days notice before shutting down a plant is an example of the rising sensitivity to this issue. The legislative responses have been the result of the most visible and painful impact that takeovers yield, i.e. the short-term loss of jobs and other negative impacts on company towns.

Table 1
Corporate Acquisitions Scoreboard

YEAR	# ACQUISITIONS	\$ VALUE (billions)
1980	1,565	\$ 33.0
1984	2,999	\$ 124.8
1985	3,001	\$ 179.8
1986	3,356	\$ 176.6
1987	2,032	\$ 163.7

Corporate managements have argued that takeovers, or the threat of takeovers, distract them from a commitment to the long-term, and instead force them to pump up short-term earnings at the expense of R&D and other long-run initiatives. (The raiders of takeover artists suggest that their targets happen to be the victims of inept management, and that they are merely interested in making sure that the shareholders get fair returns on their investments. "Takeovers protect shareholders from mismanagement of a corporation as they allow alternative management teams to compete for the right to manage the corporation's assets." (Jensen, 1984).

Corporate debt is on the rise. The debt of non-financial companies has doubled to \$1.8 trillion during the past six years while the equity base has sunk by \$400 billion. (*Business Week*, 11/7/88). However, per the aforementioned article, U.S. companies are about 50% less leveraged than their counterparts abroad.

Some Less-Known Facts About Takeovers

On the issue of managerial competence, if one looks back at the sixties and the seventies one sees a track record of companies engaging in acquisition strategies that have not really benefitted the shareholder at all. These acquisition strategies were based on portfolio theories of diversification. Michael Porter's (1987) study of diversified companies has shown that these diversifications have not been beneficial, particularly from the shareholder's point of view, as originally theorized. There is little agreement among academic researchers on whether related diversification necessarily yields better results than unrelated diversification. Also, if we had such emancipated managements to begin with then how can we, for example, explain the debacle of our basic industries? To blame it on cheap overseas labor costs alone is to take the easy way out.

A point that lies at the heart of the takeover debate, but gets overlooked, is whether the investment market is a better judge of a com-

pany's value, both in the long-term and short-term, than is its' management. Wall Street has often been portrayed as being excessively focused on the short-run. In truth, many companies, in diverse industries such as high-tech and pharmaceuticals, that have been managed for the long-run are doing well on Wall Street, (i.e., Digital Equipment Corporation, 3M, Merck and Johnson & Johnson). The assumption that shareholders always prefer short-term profits over a long-term earnings stream is at best untested and an unfair characterization of the shareholder as being myopic.

The takeover debate really focuses on who should be the instigator of corporate restructuring, management or some external agent such as a corporate raider. It would appear that irrespective of who the architects of restructuring are, it is a necessary activity if American business is to become more competitive; the presence of takeover threats forces management to ask hard questions of itself, re-examining the corporate mission, strategies, structure and performance in terms of market relevance. Such a critical analytical management philosophy can only benefit the company in the long run. "The takeover market provides a unique, powerful and impersonal mechanism to accomplish the major restructuring and redeployment of assets continually required by changes in technology and consumer preferences." (Jensen, 1984).

Without minimizing the devastation that a recession can cause to highly leveraged companies, it is important to recognize the positive effects that leveraging can have. While the use of credit in personal purchase decisions seems culturally acceptable in the U.S., businesses have been more conservatively inclined. It is only in recent years that more and more companies are recognizing that the cost of equity more often than not exceeds the cost of debt. Trading equity for debt spreads earnings over a lower equity base which translates into a higher ROE. The economic environment with its moderate interest rates makes debt highly attractive. The debt obligation gives management the latitude to make the tough asset redeployment and cost-

cutting decisions that are necessary to be competitive.

There is empirical evidence, according to Glenn Yago and his colleagues, which reveals that companies that have used high-yield financing, (such as junk bonds), and engaged in extensive restructuring have in fact shown substantial improvements in productivity, sales, capital spending, and employment, (*Wall Street Journal*, 7/28/88). The evidence indicates that several of these companies were able to afford and make the kinds of critical investment decisions that might have otherwise been impossible if they had to rely on equity financing or on investment grade bond financing.

About the fears of a recession there is some encouraging information. Given George Bush's stated bias toward growth-oriented economic policies it is reasonable to expect policies that will be anti-recessionary in nature. Those who advocate public policy structures against takeovers often raise the bogeyman of America's decline. They see the rising debt structure, corporate and federal, as an ominous sign of an irreversible decline. They ignore several facts in arriving at their conclusions.

The absolute size of the twin deficits, trade and budget, is meaningless. As a proportion of GNP, the national debt in Japan is higher than that of the U.S. The statistics of international trade, according to several experts, is seriously flawed. Estimates of our trade indebtedness are erroneously high according to Charles Wolf of Rand Corporation (Wall Street Journal, 1/6/88). Using 1980 as a base year of comparison, instead of 1950 which is traditionally used but represents a point too soon after World War II, he found that the U.S. economy's share of global product has remained constant around the 22-24% range. The projections for 2010 are that it will remain within this range because of higher growth rates forecast for newly industrialized countries and Japan, and lower rates for Western Europe and the Soviet Union.

Also, according to James Griffin (*Fortune*,

8/29/88) there are other factors that argue against the specter of decline:

Demand for U.S. government debt securities has outstripped supply as evidence by the rise in its prices.

Our borrowings from overseas are in dollars which effectively means that we have passed on some of our debt burden to foreign holders.

U.S. indebtedness has been, in part, the result of its efforts in previous years to boost the economies of its trading partners. This has led to a stronger and more closely-knit industrialized world and also to the opening up of strongly communist nations such as China and the Soviet Union to Western capitalism.

One of the most important, and somewhat distressing, facts is that as a society we seem to be cultivating a mentality of entitlement while conveniently ignoring the fundamental tenets of our culture. It is the spirit of entitlement that has created, in the corridors of political power, an intricate lobbying apparatus for every conceivable interest group. The consequences of this is the paralyzing of political decision-making, over-regulation, and destructive interference in the competitive marketplace.

Focusing just on the issue of takeovers, it is apparent already that the forces that were conducive to takeovers are changing. The RJR Nabisco LBO is particularly instructive in this regard. The board of directors changed its' stance from being compliant to one of challenging management decisions and strategies. Also, one of the key architects of the takeover frenzy, Mike Milken the junk bond wizard of Drexel Burnham Lambert, is at this writing, under indictment and his plight has dampened the takeover activity somewhat. The important point though is that most business activities reveal a natural cyclical pattern, which is almost Newtonian. Governmental intervention only confounds the issue without necessarily solving anything. One has only to remember the Great War on Poverty launched by the Johnson ad-

ministration.

Empirical Analysis of Hostile Takeovers

We chose 1984 as the year of analysis for firms that were subject to hostile takeovers. This met the twin criteria of high frequency of takeovers in combination with at least a three-year elapsed time to assess temporal effect of the takeovers. Compared with the total number of acquisitions in 1984, 2,999 with a value of \$1 million or more, the actual number of completed hostile takeovers was minuscule. Of the ten successful (as defined by W.T. Grimm, 1985) only seven involved complete ownership changes. Three of the deals classified as takeovers actually involved only a percentage ownership stake in the target firms. (Our empirical analysis does not consider those three firms). Table 2 shows the seven successful hostile takeovers of 1984.

The target firms tended to be rather healthy prior to takeover based on ratios for the seven firms in the year prior to their being purchased. The ratios included profitability ratios and asset utilization ratios. The authors, through a search of secondary sources, were able to uncover the following post-takeover performance data on the firms acquired in a hostile manner in the year 1984:

Scovill Inc.: After being bought by First City Properties, (the Bletzberg's), for \$425.6 million in 1984, the following events took place: (1) Sell-off of the Schrader Bellows unit, (pneumatic valves), to Parker Hanifen Corporation for \$77.5 million; (2) Sell-off of the automotive parts unit to Arvin Industries for \$39.2 million; (3) Sell-off of the Hamilton Beach unit to Glen Dimplex Ltd. for \$90 million; (4) Sell-off of a 19.9% stake in the French appliance unit, Mouilinox, to James Capel for \$49.75 million; (5) Sell-off of Nutone, (door chimes), and Yale Security, (locks), to Valor P.L.C. for \$460 million; (6) Cumulative value of sold-off units came to \$716.45 million, a paper gain of \$291.45 million compared to the takeover purchase price of \$425 million. The only remnant left of Scovill Inc. is the Apparel

Fastener Division, (snaps and zippers). Table 4 shows the performance data from 1986 and 1987.

Aegis Corporation: Minstar, (Irwin Jacobs), bought Aegis for \$59 million in 1984. Aegis was a holding company for five diverse subsidiaries that had the following financial performance the year preceding the takeover (See Table No. 5). Within 90 days, Irwin Jacobs sold off the Foundry, Shipyard and Energy Services divisions. He also shut down the corporate office in Coral Gables, Fla. saving \$3.5 million per year. After selling off the less profitable units for \$8-\$10 million, the net investment was about \$50 million and the profits being generated were over \$24 million per year!

American Motor Inns: Prime Motor Inns, (PMI), bought AMI in 1984 for \$242.5 million. At the time of the purchases, AMI had 7,700 hotel rooms. Since the purchase, PMI has disposed of 5,900 of these rooms returning proceeds of \$325 million. This resulted in a gain of \$82.5 million and still left Prime Motor Inns with what they deemed the 1,800 most valuable rooms in what once was American Motor Inns. As of 2/16/88, per Shearson Lehman, PMI is one of the most profitable lodging companies in the U.S., catering primarily to business travelers.

Jonathan Logan Inc.: United Merchants & Manufacturers Inc. bought Jonathan Logan Inc. for \$170.3 million in 1984. Information on what is left of Jonathan Logan continues to be available in UM&M financial reports under "Apparel Sales" (See Table No. 6). No public information was available on the disposal of any Logan units after takeover. However, the pre-takeover sales and profit figures lead one to the conclusion that at least a portion of the Logan unit was disposed of in some manner after being acquired by UM&M. In 1983, the year prior to being taken over, Logan had a net income of \$18.7 million on sales of \$382.6 million.

Medford Corp.: Amalgamated Sugar, a division of Harold Simmons' Valhi Corporation, bought Medford in 1984 for \$195.8 million.

Table 2
1984 Completed Hostile Takeovers

Hostile Buyer	Target Company	Purchase Price
Gulf & Western	Prentice-Hall	\$705.3 million
Hanson Trust PLC	U.S. Industries	468.9
First City Properties	Scovill Inc.	425.6
Prime Motor Inns	American Motor Inns	242.5
United Merchants & Manufacturers	Jonathan Logan Inc.	170.3
Almalgamated Sugar	Medford Corp.	105.8
Minstar Inc.	Aegis Corp.	59.0

Source: W.T. Grimm & Co.

Table 4
"New" Scovill Inc. Performance

Year	Sales	EBIT	Net Income (loss)
1986	\$124 Mill.	\$51 Mill.	(\$45.0 Mill.)
1987	\$133 Mill.	\$51 Mill.	(\$14.5 Mill.)

Table 5
Aegis Corporation Performance pre-takeover

Subsidiary	'83 Revenues	Gross Profit
Rubber Products	\$67.6 Mill.	\$17.0 Mill.
Foundry	7.7	.6
Savannah Shipyard	8.2	1.4
Pleasure Boats	86.2	12.7
Energy Services	10.0	3.5
	<u>\$179.7 Mill.</u>	<u>\$35.2 Mill.</u>

Table 6
Jonathan Logan Inc. Performance, Post-Takeover

Year	Sales	Operating Income (Loss)
1985	\$125 Mill.	\$14.8 Mill.
1986	148	(0.8)
1987	144	(3.7)

Table 3
Key Ratios of Target Firms

Ratio	Definition	'83 Average	'83 Range
Gross Profit Margin	Total margin available to cover internal operating expenses and yield a profit	20.8%	8.8-37.1
Return on Total Assets	Measure of the return on total investment in the firm	6.4%	3.4-9.7
Earnings per Share	Earnings available to the owners of common stock	\$2.09	.30-3.93
Current Ratio	Extent to which claims of short-term creditors are covered by assets that are expected to be converted to cash in a period roughly corresponding to the maturity of the liabilities	2.12	1.54-3.25
Quick Ratio	Measure of firm's ability to payoff short-term debts without relying on the sale of its inventories	1.23	.85-1.99
Debt to Assets	Extent to which borrowed funds have been used to finance the firm's operations	.45	.37-.53
Debt to Equity	Another measure of the funds provided by creditors vs. funds provided by owners.	.91	.65-1.21

The major attraction of Medford was its' 90,000 acres of underdeveloped timberland in Oregon. In 1983, the year prior to being acquired, Medford had a net income of \$7.1 million on sales of \$117.4 million. The only financial figures found on the post-takeover Medford showed 1987 operating income of \$6.7 million on sales of \$69.9 million.

The authors also looked at key financial indicators of the acquiring firms and made the following observations with regard to key business ratios in the year following the takeovers:

Quick Ratio: Went down in all but one of the acquiring firms.

Current Ratio: On average, it went down slightly.

Inventory Turnover: On average, improved slightly.

Net Sales/Employees: Tended to improve.

Total Liability/Total Assets: On average, remained about the same.

Total Debt/Equity: Debt tended to increase in relation to equity.

Net Income/Net Sales: On average, went down slightly.

Summary of Empirical Findings

The original objective of this research effort was to determine if firms acquired in hostile takeovers tended to perform better or worse after they were taken over. What is apparent, on reviewing the quantitative and qualitative data, is that seldom do firms maintain their original form after a contested takeover. The most illustrative examples of this from our analysis of the 1984 contested takeovers are Scovill Inc., Aegis Corporation, and American Motors Inns. In each case, the acquiring firm quickly sold off all marginal performers, choosing to maintain only the most profitable units. In each case, this strategy proved to be quite profitable for the acquirers.

The irony one sees in examining these transactions is that the management of the firms that were acquired could have followed the same

strategy and been even more profitable than the "raiders". This is easier said than done however, when one considers that the typical top managers of a firm have years of personal equity in each unit of their business. They may find it more difficult to step back and take a cold, objective look at what makes most sense to the financial well being of the corporation than an outsider. The corporate raider, not burdened by these personal attachments, is free to look at each business unit only as an investment. Thus, the typical raider quickly disposes of the underperforming units much more easily than entrenched management would have.

The outcomes of these jettisons is a "reallocation of underused resources and a more efficient, stronger economy." In a *Wall Street Journal* article titled, "Blaming the Investor", Doug Bandow (1988) noted the positive impacts of the threat of and consummation of hostile takeovers: "Nothing seems to focus a business executive's attention quite like a corporate raider." Bandow went on to note, "Over the past two decades merger activity has roughly tracked manufacturing productivity rates. Indeed, takeovers have been concentrated in sectors of the economy with substantial productivity gains."

In summary, we agree with the following observations by Michael Jensen (1984):

The takeover market provides a unique, powerful, and impersonal mechanism to accomplish the major restructuring and redeployment of assets continually required by changes in technology and consumer preferences. As market struggles for corporate control serve to increase efficiency and shareholder's wealth, measures designed to prevent or deter these will weaken the corporation as an organizational form and reduce human welfare (p. 109).

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