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To Our Clients:

The Takeover Frenzy

1988 has witnessed an amazing resurgence of takeover activity. Less than six months after the October 19 market crash takeover activity is higher than at any time before the crash. So far this year more than $72 billion of takeover bids have been announced, twice that of this time last year. There is no one explanation for the renewed takeover frenzy. However, it is possible to identify a number of factors that contribute. Some of the factors overlap and some are more significant than others. In combination they explain today's takeover activity.

Cultural changes. There is no longer any cultural barrier to a hostile takeover bid. Corporate raiders are glorified on the covers of magazines and on television. This year has seen J.P. Morgan act for a Swiss company, Hoffman LaRoche, in a tender offer for Sterling Drug, a long-time Morgan banking client; Shearson Lehman Hutton join as an equity partner with a British company to make a hostile bid for Koppers; General Electric, a pillar of the Business Roundtable and the corporate establishment make a hostile bid for a small appliance manufacturer, Roper; Emhart, a major company in Hartford Connecticut, become the first company in a close business community like Hartford to

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make a hostile bid for another company in the same community; the spread of takeover activity to continental Europe and the concommitant willingness of European companies to make hostile bids in the U.S.; and the beginning of Japanese participation with the Bridgestone white knight bid of $80 per share ($2.6 billion) for Firestone after a hostile bid of $58 per share ($1.9 billion) by Pirelli and Michelin.

Director attitudes. Boardroom attitudes have changed. Management is no longer restrained by fear that directors will look askance at a proposal to make a hostile bid. Many companies believe that if they are not taking over others and not increasing their size and leverage they will become targets. To remain independent they have become raiders. Target directors are less willing to fight to remain independent and seem more concerned to avoid being embarrassed by a charge of failure to maximize shareholder values than to preserve independence.

Availability of financing. First Boston developed the bridge loan to compete with Drexel Burnham's junk bonds. Now all the investment banks provide bridge loans to be refunded with junk bonds and the major commercial banks are competing with the investment banks to provide takeover financing. A fair estimate of the aggregate equity funds for acquisitions held by the scores of leverage buyout funds

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(many started since October 19) is more than $25 billion. Leveraged at five-to-one, which is quite low compared to the ten-to-one in many recent transactions, the $25 billion would support $125 billion of acquisitions. Money to finance takeovers is available in unlimited amounts.

Cheap dollar and cheap companies. The decline in the dollar against the yen and the European currencies, lower market prices post-October 19 and lower price-earnings ratios for U.S. companies than for those of most non-U.S. companies makes U.S. companies cheap. This has created a unique opportunity for non-U.S. companies to bid for U.S. companies such as the tender offers this year by Hoffman LaRoche for Sterling Drug, BAT Industries for Farmers Group, Campeau for Federated Department Stores, Pirelli for Firestone, Beazer for Koppers and Hachette for Grolier. The U.S. is still the safest safe haven and there is still a great desire by foreigners to diversify into the U.S.

Strength of U.S. economy. The October 19 crash did not (at least not yet) result in a recession. It merely lowered stock market prices to a level where they became attractive to corporate strategic buyers. The economy today appears strong with more concern about inflation than recession. Inflation encourages acquisitions in that assets appreciate in value and the debt incurred to buy the assets decreases in value.

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Retreat of the raiders, return of the strategic buyers. For several years prior to 1988, takeovers were dominated by corporate raiders and their junk-bond-financed, boot-strap, bust-up takeovers. The 1987 change in the tax law eliminating devices which allowed a raider to liquidate a target on a tax favored basis has reduced the incentive for bust-up takeovers and in many cases results in a price advantage to a buyer who does not plan to resell a significant part of the acquired assets. Similarly, an internal restructuring of a company has become more competitive in price with a bust-up takeover. Thus, the bust-up raiders have taken to the sidelines. They still go on to the playing field, but not so often. This has brought back the strategic buyers. Less competition from raiders, lower market prices post-October 19 and fear that the next Administration may be restrictive of takeovers have combined to make hostile bidders of acquirors who previously would undertake only a negotiated acquisition.

Institutional investor control. With the ownership of a majority of the shares of most major companies in the hands of institutional investors it has become virtually impossible to defend against a takeover. The institutions have become activists in opposing takeover defenses, voting for corporate raiders in proxy fights and forcing companies to auction themselves to the high bidder. One is hard

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pressed to name even one company which during the past three years became the target of a cash tender offer for all of its shares and managed to remain independent and unrestructured. Today institutional investors are not just insisting on a takeover premium when a company is put in play, they are actively promoting takeovers.

Permissive attitude of the regulators and the courts. The SEC, FRB, ICC, CAB, FCC and the Administration generally favor takeovers, oppose legislation that would restrict takeovers and enforce the law (or refuses to enforce the law) in a manner that favors the raider over the target. There is a sharp tilt of the playing field in favor of the raider. The only effective brakes on takeover activity -- the poison pill and state takeover statutes -- are under constant attack by the SEC and the Administration. The courts have caught takeover fever and do not hesitate to second-guess directors who are seeking to preserve the independence of their company. Whereas once the main focus of takeover litigation was the target's effort to enjoin the raider, today it is the raider's efforts to enjoin a restructuring defense by the target.

Market encouragement of leverage. The standards for the ratio of debt to equity have reversed so substantially that where once it was thought too risky to have debt

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greater than half of equity, today debt ten times equity is applauded. The highly leveraged company is accorded a premium price in the market. The stub shares of highly leveraged, restructured companies sell at prices not based on earnings or assets, but as calls on what the earnings might be in five years or more. The premium for leverage is a major factor in promoting takeovers. Indeed, the market today so deeply discounts unleveraged future growth that there is a significant disincentive to invest in research and development and new plants and equipment.

The attraction of LBOs. The LBO gives management a greater equity stake than the customary stock incentives in most public companies. For professional managers there is a great attraction to getting away from worrying about quarter-to-quarter earnings performance and instead being able to manage with the objective of maximizing cash flow. Many managers today believe that if a company is subject to being raided there is no reason not to be preemptive and attempt a leveraged buyout. With the huge amount of LBO capital available there is great momentum behind the LBO movement. It has become a major factor in the rationalization of American business. It continues to grow at a very rapid pace.

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The takeover infrastructure. Almost every large company has an acquisition staff. All the major law firms and accounting firms have merger and acquisition departments. Takeovers are the most profitable investment banking activity. So profitable that the major commercial banks have developed large merger and acquisition departments to compete with the investment banks. Boutique investment banking firms are springing up and, large and small, all the firms want to be merchant bankers with direct equity participation in takeovers. The expanding infrastructure is a driving force in expanding takeover activity.

Decline of community and union opposition. The days of the Bartlesville prayer meetings and the Pittsburgh union demonstrations are gone. Today, except for the attack by the state of Pennsylvania and the city of Pittsburgh on Shearson Lehman for participating as an equity partner with Beazer in its hostile bid for Koppers, communities rarely come forward to protest the takeover of local companies. Indeed, as illustrated by the efforts of the United Airlines and PanAm unions to takeover those companies, unions have become raiders.

Takeovers have become a world-wide phenomenon. The current resurgence following the October 19 crash is explained by some on the basis of one or two factors. At any

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one point in time one or two factors may be dominant. However, after 15 years of world-wide growth of takeovers the conclusion is inescapable -- they are not a temporary aberration. They reflect a universal fundamental aspect of public ownership of major business entities in democractic societies. The debate as to whether takeovers are good or bad, whether they enhance efficiency, whether they impede long-term planning, whether they create dangerous levels of leverage, whether they are essential counter-balances to trade deficits, will continue. Respected opinion is lined up on either side of each issue. However one feels about these issues, the fact is takeovers have become a major aspect of the free-world economies.

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