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THE NEW MERGER WAVE

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The most frequently asked questions about the current resurgence of merger activity are: (1) what are the business reasons for the renewed activity, (2) what is the macroeconomic impact of the large number and very large size of today's mergers and (3) what explains the governmental policies that allow them to happen. There is no single or simple explanation. Unlike the financially-motivated highly-leveraged bust-up takeovers of the 1980's, most of the current mergers are soundly financed, strategically motivated, improve efficiency, increase productivity and competitiveness, and result in better products and services at lower real prices. They are also increasing, not decreasing, employment over the long run.

Experience indicates that one or more of the following factors are present in most of today's mergers:

1. Sharing the benefits of an improved operating margin through reduction of operating costs. Many of today's acquisitions involve a company with a high operating margin acquiring a company with a lower operating margin. By improving the acquired company's operations, the acquiror creates cost and/or revenue synergies that pay for the acquisition premium and provide additional earnings for the acquiror's shareholders.

2. Sharing the costs and benefits of eliminating over capacity. The sharp reductions in the defense budget in recent years have resulted in defense contractors consolidating in order to have sufficient volume to remain profitable. The Defense Department has encouraged the consolidations to assure that its suppliers remain healthy. The pressure to control healthcare costs has had a similar impact in the healthcare industry. The recent joint-venture consolidation of refining and marketing operations by oil and gas companies is another example of the effort to reduce costs by eliminating over-capacity.

3. Integrating back to the source of raw material or forward to control the means of distribution. Over the years vertical integration has had a mixed record. Currently it has a poor record in media and entertainment, particularly where "hardware" companies have acquired "software" companies. However, vertical integration continues to be a motivation for a significant number of acquisitions, and, as noted below, is being widely pursued as a response to the Internet.

4. The advantage or necessity of having a more complete product line in order to be competitive. This is particularly the case for companies like suppliers to large retail chains that prefer to deal with a limited number of vendors in order to control costs of purchasing and carrying inventory.

5. Availability of highly desirable acquisitions through privatizations by formerly socialist or protectionist governments. This has accounted for a significant number of cross-border acquisitions. In the utility industry where much of the privatization activity has taken place, 10 of the 12 British electricity companies were acquired in 1996, 3 by American companies.

6. The need to spread the risk of the huge cost of developing new technology, e.g. new airplanes and jet engines and pharmaceuticals.

7. Response to the global market -- market penetration through acquisition or joint venture with a local partner.

8. Response to deregulation. Banking, insurance, money management, healthcare, transportation and utilities are industries that have experienced mid-90's mergers as a result of deregulation. Recent examples are the acquisition of investment banks by commercial banks following the Federal Reserve's relaxation of restrictions on

securities activities by commercial banks, and the cross-border utility mergers following the relaxation of state utility regulation.

9. Concentration of management energy and focus. The 90's have witnessed a recognition by corporate management that it is frequently not possible to manage efficiently more than a limited number of businesses. Similarly, there has been recognition that a spinoff can result in the market valuing the separate companies more highly than the whole. These factors have resulted in the spinoff or sale of noncore businesses by a large number of companies. In 1996 there were 20 spinoffs with a value of more than $500 million.

10. Response to change in technology. Rapid and dramatic developments have lead companies to seek out acquisitions to remain competitive. Cogent examples are the acquisitions by telephone, software, cable and media companies designed to place them in a position to compete in an era of high-speed Internet access via cable in which people interact with the World Wide Web for news, information, entertainment and shopping.

11. The receptivity of both the equity and debt markets to large strategic transactions. Equity investors have been willing to accept substantial amounts of stock issued in mergers and have encouraged deals by supporting the stock of the acquiror. In recent years, many equity acquisitions have seen the acquiror's stock go up on announcement of the deal. Over 60% of the value of 1996 acquisitions was in the form of stock. The mid-90's debt markets have provided both liquidity at size and favorable rates.

12. Pressure by institutional shareholders to increase shareholder value. This pressure has been felt by boards of directors and they have responded by urging management to take actions designed to maximize shareholder value. This has resulted in divestitures of noncore businesses and sales of entire companies in some cases and in others it has been the impetus for growth through acquisitions designed to increase volume, expand product lines or open new geographic areas.

13. Response to changes in the capital markets. The ongoing shift from private financing to public financing in the commercial real estate markets which is evidenced by the marked growth in the public REIT industry has brought with it pressure to consolidate and make more liquid the ownership of the approximately $3 trillion of U.S. commercial real estate. Existing public REITs are

seeking to grow through acquisitions in order to increase stock liquidity and access to capital, while at the same time pension funds, insurance companies and other private investors are seeking to swap their properties for more liquid stock in publicly traded REITs.