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Mergers: Past, Present and Future

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In my year-end review of merger activity I referenced several of the exogenous factors in 2000 that resulted in a significant decrease in the volume of mergers in the latter part of the year. These factors and the autogenous factors that motivate mergers deserve further examination, not just with respect to 2000 but as to how they may affect future merger activity. Before embarking on this examination it must be noted that macro-economic factors and government policies in large measure shape the factors that affect merger activity. Thus, the factors affecting mergers have cycles that can change dramatically with shifts in the world and domestic economy and changes in governmental policies.

Exogenous Factors Affecting Mergers

First, the exogenous factors. They are listed in alphabetical order because they vary in order of importance from deal to deal and from time to time, and it is not feasible to attempt to rank them in order of importance.

Accounting. The availability of pooling accounting for mergers has been a significant factor in the 1990s merger activity. Pooling avoids dilution of earnings brought about by the recognition and mandatory amortization of goodwill when a merger is accounted for as a purchase. As pooling came under increasing pressure from the SEC and the FASB, its impending demise, first at the end of 2000 and then in the first-half of 2001, undoubtedly acted as a

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stimulant for some mergers, but it is not possible to gauge accurately how many deals were undertaken in 1999 and 2000 to beat the deadline. Now, at the beginning of 2001, the FASB is proposing that purchase accounting replace pooling but that goodwill should not be automatically written down, but instead should be subjected to a periodic impairment test. An impairment charge would be taken when the fair value of goodwill falls below its book value. This method of accounting could be even more favorable for mergers than pooling in that it will avoid amortization of goodwill and not saddle the merged companies with the restrictions against share repurchases and asset dispositions that encrust the pooling rules. Thus, accounting will basically be a neutral factor in 2001 and the foreseeable future, neither significantly stimulating nor restraining mergers.

Antitrust. Government policy can promote, retard or prohibit mergers and is a major factor affecting mergers. The antitrust regulators in the U.S. and the EU have been reasonably receptive to mergers. They have recognized that markets are global and have accepted divestitures, licenses and business restrictions to cure problems. The "big is bad" concept has been abandoned. At this time it appears that the EU has become a bit more restrictive and the U.S., with a change in administration, will be a bit less restrictive. The overall situation can be summarized: Current antitrust enforcement policies will not unduly restrain mergers in 2001.

Arbitrage. Arbitrageurs, together with hedge funds and activist institutional investors are a major factor in merger activity. They sometimes band together to encourage a company to seek a merger and sometimes to encourage a company to make an unsolicited bid for a company with which they are dissatisfied. By accumulating large amounts of stock of a company to be acquired, they can, and frequently are, a factor in assuring the shareholder vote necessary to approve a merger. They will continue to be a force both facilitating and promoting mergers.

Currencies. Fluctuations in currencies have an impact on cross-border mergers and current conditions in the foreign exchange markets have contributed to the slowdown in merger activity. The sharp decline in the Euro during 2000 was a deterrent to European acquisitions of U.S. companies. The strong dollar and weak Asian currencies led to a significant increase in acquisitions by U.S. companies in Asia. The recent strength in the Euro has not had time to become a factor in mergers. The uncertainty as to the U.S. economy, the U.S. trade deficit and the strength of the dollar portend at best slow growth of cross-border acquisitions of U.S. companies.

Deregulation. The worldwide movement to market capitalism and privatization of state controlled companies has led to a significant increase in the number of candidates for merger. The concomitant change in attitude toward cross-border mergers has had a similar effect. Deregulation of specific industries – like financial institutions, utilities and radio and television in the U.S. – has also contributed to an increase in mergers.

Experts. The development of experts in conceiving, analyzing, valuing and executing mergers has been a significant factor. While some consider this to be phenomenon of the 1980s, it in fact dates to the turn of the 20^{th} Century when JP Morgan merged the Carnegie steel interests with a number of others to create U.S. Steel. The fact that global investment banks are calling merger opportunities to the attention of all the major companies in the world is a merger stimulant. So too the availability of specialized lawyers, consultants and accountants to provide backup and support to the managements and directors of merging companies has been a merger stimulant.

Hostile Bids. With the demise of the financially motivated bust-up bids of the 1970s and 1980s, and the shift to strategic transactions, major companies have been willing to make hostile bids. General Electric, IBM, Johnson & Johnson, AT&T, Pfizer, Wells Fargo and Norfolk Southern are some of the companies that have done so. In addition there has been a dramatic increase in hostile bids in Europe. The $202 billion record-setting bid by Vodafone for Mannesmann being the prime example. The willingness of continental European governments to step back and let the market decide the outcome of a hostile bid has opened the door and led to a significant increase in European hostile bid activity. In the U.S. the success rate for strategic hostile bids by major companies has similarly led to an increase in activity.

Labor. The general prosperity and full employment in the U.S. in the 1990s resulted in weakened resistance to mergers by the employees of acquired companies. As long as there is a vibrant job market, employee resistance to mergers will not be meaningful. It should be noted that the present debate in the EU with respect to the long-pending merger legislation revolves around a last-minute attempt to require company boards to consider employees as well as shareholders prior to effectuating a merger and to authorize target companies to adopt takeover defenses.

LBO Funds. The growth of LBO funds from a humble beginning in the 1970s to the mega-funds of the 1990s has been a significant factor in acquisitions. With tens of billions of dollars of equity to support leverage of two to three to one, these funds have the capability of doing major deals and will continue to be an important factor.

Markets. Receptive equity and debt markets are critical factors in merger activity. Prior to mid 2000 the equity markets were very favorable for telecommunications, media and technology stocks and for five years these sectors led merger volume to new heights. This same period saw an active, growing junk bond market and ready availability of bank loans, both at attractive interest rates. With the NASDAQ down 50% from its early 2000 highs and many telecommunications, media and technology stocks down even more, stock mergers in these sectors are no longer readily doable and at this time there is little prospect of a return to conditions conducive to telecommunications, media and technology mergers. The junk bond market has virtually dried up and banks have tightened their lending standards. This has resulted in a reduction of cash acquisitions. Outside of the telecommunications, media and technology sectors, merger activity has been less impacted by the decline in the securities markets, but the uncertainty as to the economy, with concern that the landing will be hard rather than soft, has dampened the merger ardor of many companies. The January 3, 2001 action of the Federal Reserve in reducing interest rates may change market psychology and stem the fall of the equity markets. If so, that restraint on mergers will be ameliorated. A special feature of the collapse in the telecommunications, media and technology stocks is that there are now many good companies with low stock market values and a need for fresh capital that may be met only through merger with a stronger company.

New Companies. Just as the explosive formation of new companies in the latter part of the 19th Century fueled the first and second merger waves, the recent formation of thousands of new companies in the technology areas has fueled the fifth wave and will be a major factor in merger activity in the future.

Taxes. The general worldwide reduction in capital transaction taxes has lifted a restraint on mergers. For example, the pending change in German tax law – to facilitate banks selling their significant stakes in German companies – is viewed as a potential stimulant to mergers in Germany.

Autogenous Factors Affecting Mergers

The foregoing external factors are essentially beyond the ability of companies to control or even to influence significantly. While they basically determine whether a particular merger is doable at a particular time, they do not explain why companies want to merge. What are the autogenous business reasons driving merger activity? There is no single or simple explanation and again no ranking in importance is possible. Experience indicates that one or more of the following factors are present in all mergers:

Obtaining market power. Starting with the 19th Century railroad and oil mergers, a prime motivation for merger has been to gain and increase market power. Left unrestrained by government regulation it would be a natural tendency of businesses to seek monopoly power. The 19th Century Interstate Commerce Act and Sherman Antitrust Act were the governmental response to the creation of trusts to effectuate railroad and oil mergers.

Sharing the benefits of an improved operating margin through reduction of operating costs. Many of today's acquisitions involve a company with a favorable operating margin acquiring a company with a lower operating margin. By improving the acquired company's operations, the acquiror creates synergies that pay for the acquisition premium and provide additional earnings for the acquiror's shareholders. Acquiring firms may reallocate or redeploy assets of the acquired firm to more efficient uses. Additionally, intra-industry consolidating acquisitions provide opportunities to reduce costs by spreading administrative overhead and eliminating redundant personnel.

Sharing the costs and benefits of eliminating excess capacity. The sharp reductions in the defense budget in the early 1990s resulted in defense contractors consolidating in order to have sufficient volume to absorb fixed costs and leave a margin of profit. The Defense Department encouraged the consolidations to assure that its suppliers remained healthy. The pressure to control healthcare costs has had a similar impact in the healthcare industry. The mega-mergers of, and joint-venture consolidation of refining and marketing operations by, oil and gas companies is another example of an effort to reduce costs by eliminating overcapacity.

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. The pending acquisition of Time Warner by AOL is an example.

The advantage or necessity of having a more complete product line in order to be competitive. This is particularly the case for companies such as 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. A similar situation has resulted in a large number of mergers of suppliers to the automobile manufacturers.

The need to spread the risk of the huge cost of developing new technology. This factor is particularly significant in the aerospace/aircraft and pharmaceutical industries.

Response to the global market. The usual and generally least risky means of increasing global market penetration is through acquisition of, or joint venture with, a local partner. Due to the increased globalization of product markets, U.S. cross-border merger and acquisition activity has been steadily increasing. Many of the most important and largest product markets for U.S. companies have become global in scope.

Response to deregulation. Banking, insurance, money management, healthcare, telecommunications, transportation and utilities are industries that have experienced mid-1990s mergers as a result of deregulation. Examples are the acquisition of investment banks and insurance companies by commercial banks following the relaxation of restrictions on activities by commercial banks, and the cross-border utility mergers following the relaxation of state utility regulation.

Concentration of management energy and focus. The 1990s 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 resulted in the spinoff or sale of non-core businesses by a large number of companies. The amendment to the tax law eliminating new Morris Trust spinoff/merger transactions had a dampening effect on the level of spinoff/merger activity, but spinoffs have continued as a frequently used means of focusing on core competencies.

Response to changes in technology. Rapid and dramatic technological developments have led 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. For instance, AT&T's acquisition of cable companies reflected its strategy to use cable lines to form a network for local phone and internet services. Similarly, the AOL and Time Warner merger is premised on convergence of media and the Internet. Banking is another example where rapid changes in technology have sparked a significant number of mergers.

Response to industry consolidation. When a series of consolidations takes place in an industry, there is pressure on companies to not be left out and to either be a consolidator or chose the best partner. Current examples of industries experiencing significant consolidation are banking, forest products, food, advertising and oil and gas.

The receptivity of both the equity and debt markets to large strategic transactions. When equity investors are willing to accept substantial amounts of stock issued in mergers and encourage deals by supporting the stock of the acquiror, companies will try to create value by using what they view as an overvalued currency. When debt financing for acquisitions is also readily available at attractive interest rates, companies will similarly use what they view as cheap capital to acquire desirable businesses.

Pressure by institutional shareholders to increase shareholder value. Institutional investors and other shareholder activists have had considerable success in urging (and sometimes forcing) companies to restructure or seek a merger. The enhanced ability of shareholders to communicate among themselves and to pressure boards of directors has had a significant impact. Boards have responded by urging management to take actions designed to maximize shareholder value, resulting in divestitures of non-core businesses and sales of entire companies in some cases. In other cases, shareholder pressure has been the impetus for growth through acquisitions designed to increase volume, expand product lines or gain entrance to new geographic areas. The recognition by boards of directors that it is appropriate to provide incentive compensation, significant stock options and generous severance benefits has removed much of the management resistance to mergers. So too the ability of management to obtain a significant equity stake through an LBO has been a stimulant to these acquisitions.

Disregard of the supposed high rate of merger failure. Most academic studies of mergers argue that a majority of mergers are not beneficial to the acquiring company. Yet companies continue to pursue mergers. Some argue that management aggrandizement is the reason. However apart from this explanation and apart from a management belief that the deal of the moment will not be one of the failures, the academic studies are criticized and largely ignored on the grounds that they are mostly based on comparing the stock market value of the acquiring company to that of its peers or the general index for periods subsequent to the acquisition. The obvious defect in this analysis is lack of information as to how the acquiror would have fared if the acquisition had not taken place. Personal experience confirms a substantial number of failed mergers; however, my experience does not confirm the academic studies. The overwhelming majority of negotiated strategic mergers that I have been involved in over a 45-year period were successful for the acquiring company. The same cannot be said for hostile takeovers where the culture clash usually results in management disruption that causes failure. The December 27, 2000 Lex Column of the Financial Times summarized the “right recipe” for a merger:

> So what do investors want from an acquisition? The answers are much the same as they always were: deals which do not blur the lines of responsibility in an attempt to create a merger of equals; which do not serve principally the aggrandisement of the chief executive; which have some more compelling strategic rationale than merely to achieve scale in a consolidating industry; and above all, deals which create more value through the synergies they unlock than they give away in premiums paid to the target's shareholders. If possible, could they please also have some real prospects for revenue growth in the mixture, as well as just cost cuts?

Merger Waves in the United States

Historians refer to five waves of mergers in the U.S. starting in the 1890s. The starting date and duration of each of these waves is not specific, although the ending dates for those that ended in wars or in panics, crashes or other financial disasters are somewhat more definite. Indeed, it may be more accurate to say that mergers are an integral part of market capitalism and we have had continuous merger activity since the evolution of the industrial economy in the late 19^{th} Century, with short interruptions when fundamental forces turned exogenous merger factors negative.

First Period – 1893 to 1904. This was the time of the major horizontal mergers creating the principal steel, telephone, oil, mining, railroad and similar giants of the basic manufacturing and transportation industries. The Panics of 1904 and 1907 and then the First World War are pointed to as the causes of the end of the first wave, which some view as continuing through and beyond 1904.

Second Period – 1919 to 1929. This period saw further consolidation in the industries that were the subject of the first wave and a very significant increase in vertical integration. The major automobile manufacturers emerged in this period. Ford for example was integrated from the finished car back through steel mills, railroads, and ore boats to the coalmines. The 1929 Crash and the Great Depression ended this wave.

Third Period – 1955 to 1969-73. This was the period in which the conglomerate concept took hold of American management. Major conglomerates like, IT&T, LTV and Litton were created and many major established companies accepted the concept and diversified into a number of new industries and areas. The conglomerate stocks crashed in 1969-70 and the diversified companies never achieved the benefits thought to be derived from diversification.

Fourth Period – 1974-80 to 1989. Generally referred to as the merger wave, or takeover wave, of the 1980s. However, its antecedents reach back to 1974 when the first major company hostile bid was made by Morgan Stanley on behalf of Inco seeking to takeover ESB. This bid opened the door for the major investment banks to make hostile takeover bids on behalf of raiders. In addition to hostile bids, this period was noted for junk bond financing and steadily increasing volume and size of LBOs. It also was marked by insider trading scandals. This was the period that saw corporate raiders like Boone Pickens run rampant with two-tier, front-end-loaded, boot-strap, bust-up, junk-bond, hostile tender offers until the playing field was leveled by the poison pill in the mid 1980s. However, even after the poison pill, merger activity increased through the latter part of the 1980s, pausing for only a few months after the October 1987 stock market crash. It ended in 1989-90 with the $25 billion RJR Nabisco LBO and the collapse of the junk bond market, along with the collapse of the S&Ls and the serious loan portfolio and capital problems of the commercial banks.

Fifth Period – 1993 to ? This has been the era of the mega-deal. Companies of unprecedented size and global sweep have been created on the assumption that size matters, a belief bolstered by market leaders' premium stock-market valuations. High stock prices have simultaneously emboldened companies and pressured them to do deals to maintain heady trading multiples. A global view of competition, in which companies often find that they must be big to compete, and a relatively restrained antitrust environment have led to once-unthinkable combinations, such as the mergers of Citibank and Travelers, Chrysler and Daimler Benz, Exxon and Mobil, Boeing and McDonnell Douglas, and AOL and Time Warner. From a modest $322 billion of deals in 1992, the worldwide volume of combinations has marched steadily upward to $3.2 trillion worldwide in 2000. The ten largest deals in history all took place in the past three years. Most of the 1990s deals have been strategic negotiated deals and a major part have been stock deals. The buzzwords for opening of merger discussions have been, "would you be interested in discussing a merger of equals" while few if any deals are true mergers of equals, the sobriquet goes a long way to soothe the egos of the management of the acquired company. The year 2000 started with the announcement of the record-setting $165 billion acquisition of Time Warner by AOL. Through the first quarter new records were set and it looked like 2000 would be the ninth consecutive year of new highs in merger activity. However, after a five-year burst of telecommunications, media and technology mergers, we experienced a dramatic slow down in the telecommunications, media and technology sector, as well as all mergers. It started with the collapse of the Internet stocks at the end of the first quarter followed by the earnings and financing problems of the telecoms. While the fundamental pressures of consolidation, convergence, technology and globalization continue to impact the telecommunications, media and technology sector, it is unlikely that telecommunications, media and technology mergers will soon return to the level experienced in prior years and early in 2000. At year-end the NASDAQ is down about 50% from its high, many Internet, telecom and technology stocks are down more than 50%

(some as much as 98%), the junk bond market is almost nonexistent, recent merger announcements have not been well received in the equity markets, banks have tightened their lending standards and, despite the January 3, 2001 interest rate reduction by the Federal Reserve Board, there is some fear that the landing will be hard rather than soft. Given these factors, it is doubtful that merger activity will be robust in 2001. The decline will not be as severe as the 1989-1992 collapse. But it will be significant. However, the fundamental factors motivating mergers continue in bad markets as well as good and I expect 2001 to be more of a pause in the fifth merger wave than its end.

Charts

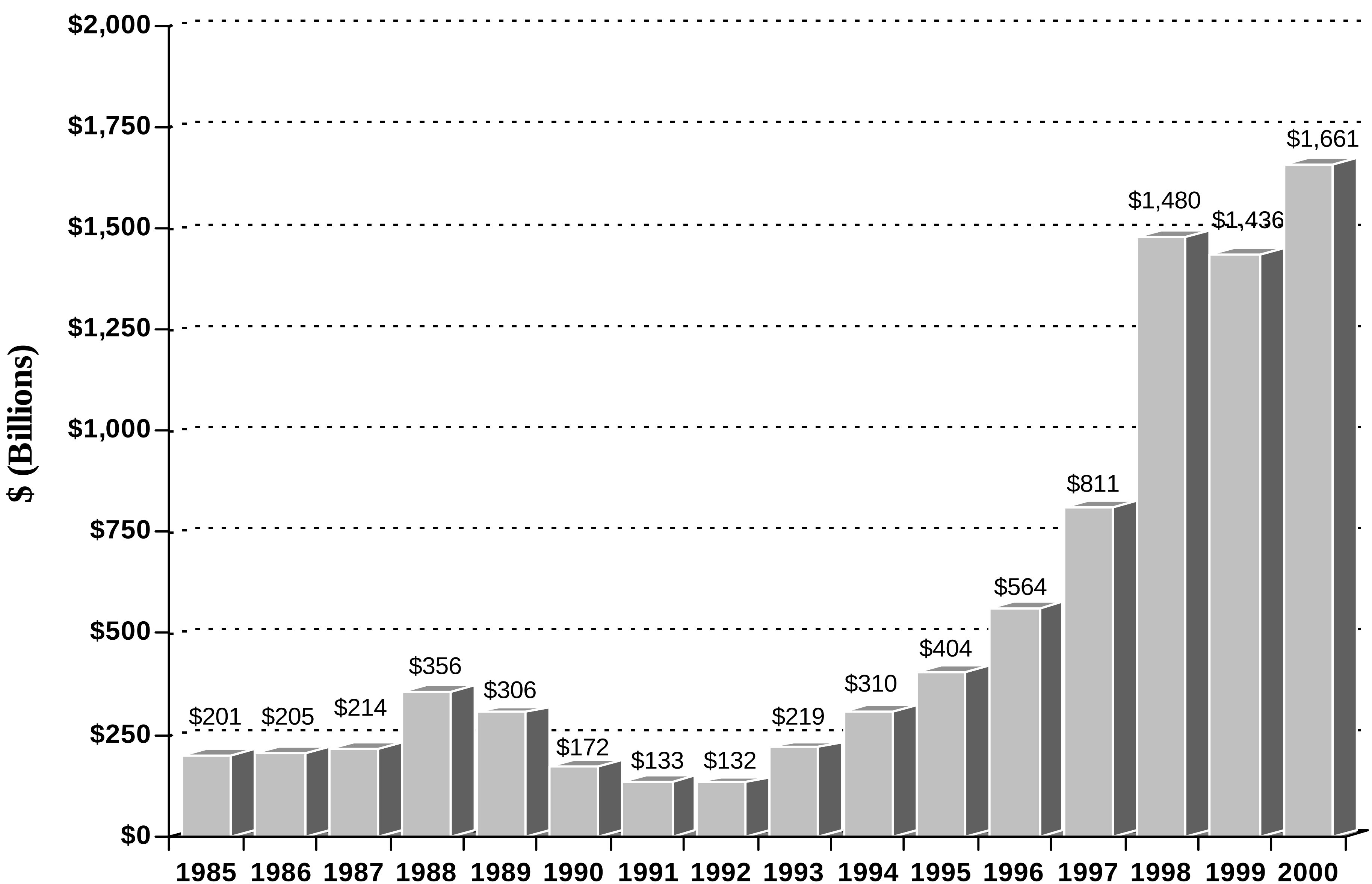
The following charts illustrate merger activity and various of its aspects:

1. Announced M&A Activity – U.S. Domestic $ Volume
2. Announced M&A Activity – Worldwide $ Volume
3. Announced Hostile M&A Activity – U.S. Domestic $ Volume
4. Announced Hostile M&A Activity – Worldwide $ Volume
5. Top Ten U.S. M&A Deals
6. Top Ten Worldwide M&A Deals
7. % of U.S. Deal Consideration Consisting of Stock
8. U.S. Acquisition Premiums
9. Hostile Offers by Strategic Bidders – U.S. Targets
10. Outcomes of Hostile Bids by Strategic Bidders

It should be noted that there is considerable lack of uniformity of merger statistics and different reporting services will use different amounts for the same transaction. The foregoing charts are subject to this defect. However, they do accurately reflect the trends from year to year and the overall increase in the size of mergers. It should also be noted that from 1991 to 2000 total market capitalization of all U.S. companies grew from approximately $4 trillion to approximately $16 trillion.

Chart #1

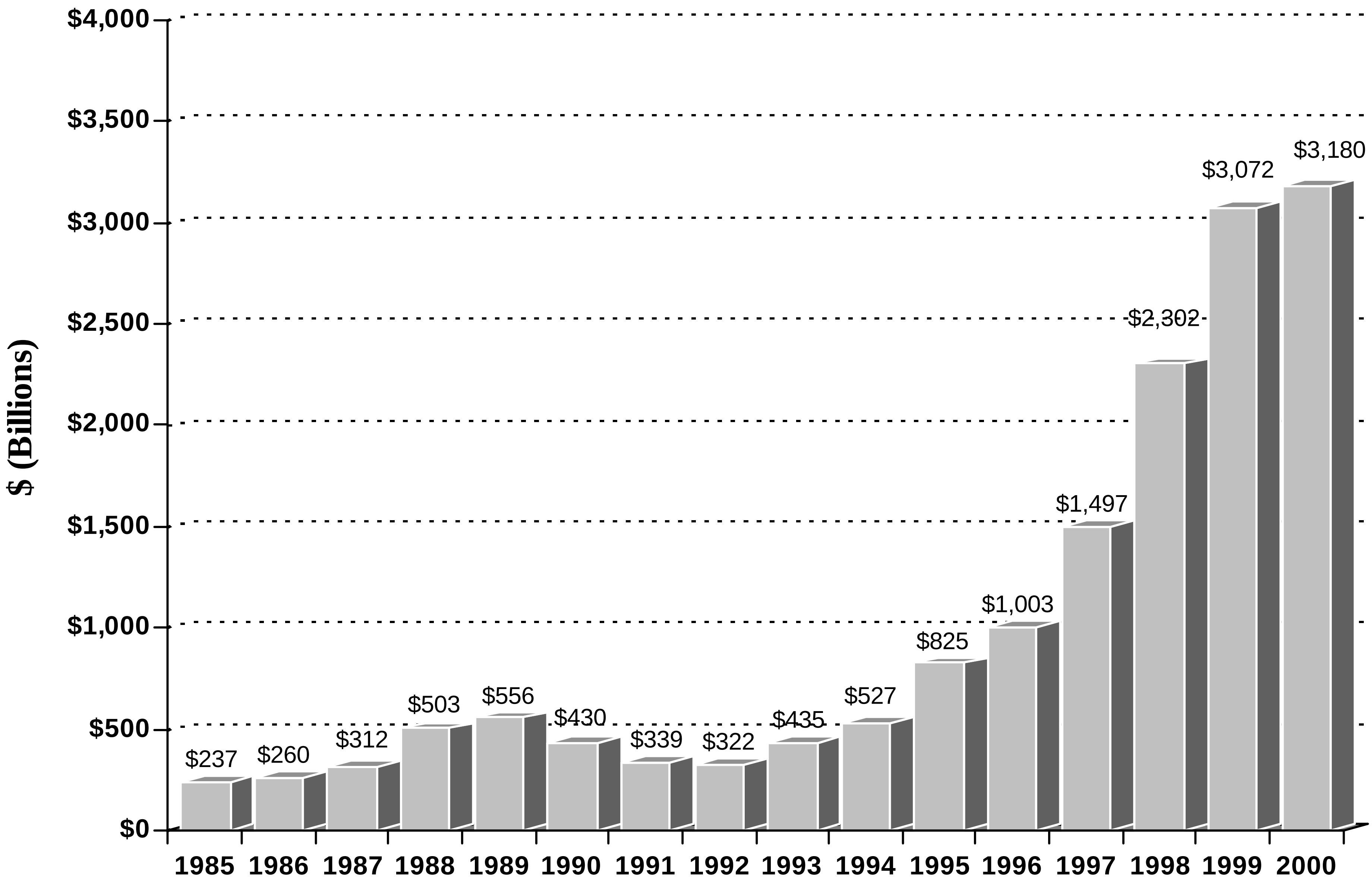
Announced M&A Activity - U.S. Domestic by $ Volume



Source: Thomson Financial Securities Data

Chart #2

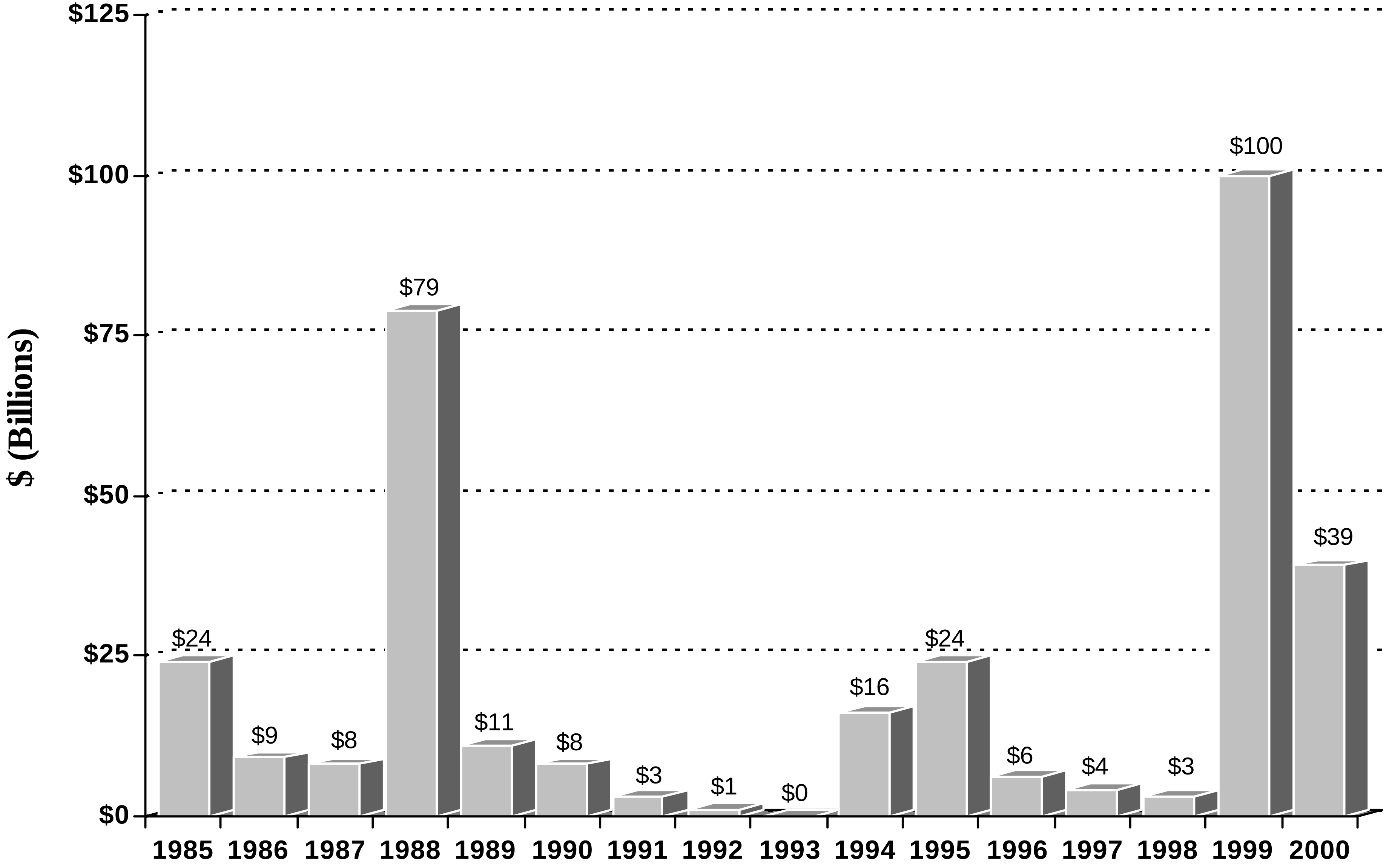
Announced M&A Activity - Worldwide by $ Volume



Source: Thomson Financial Securities Data

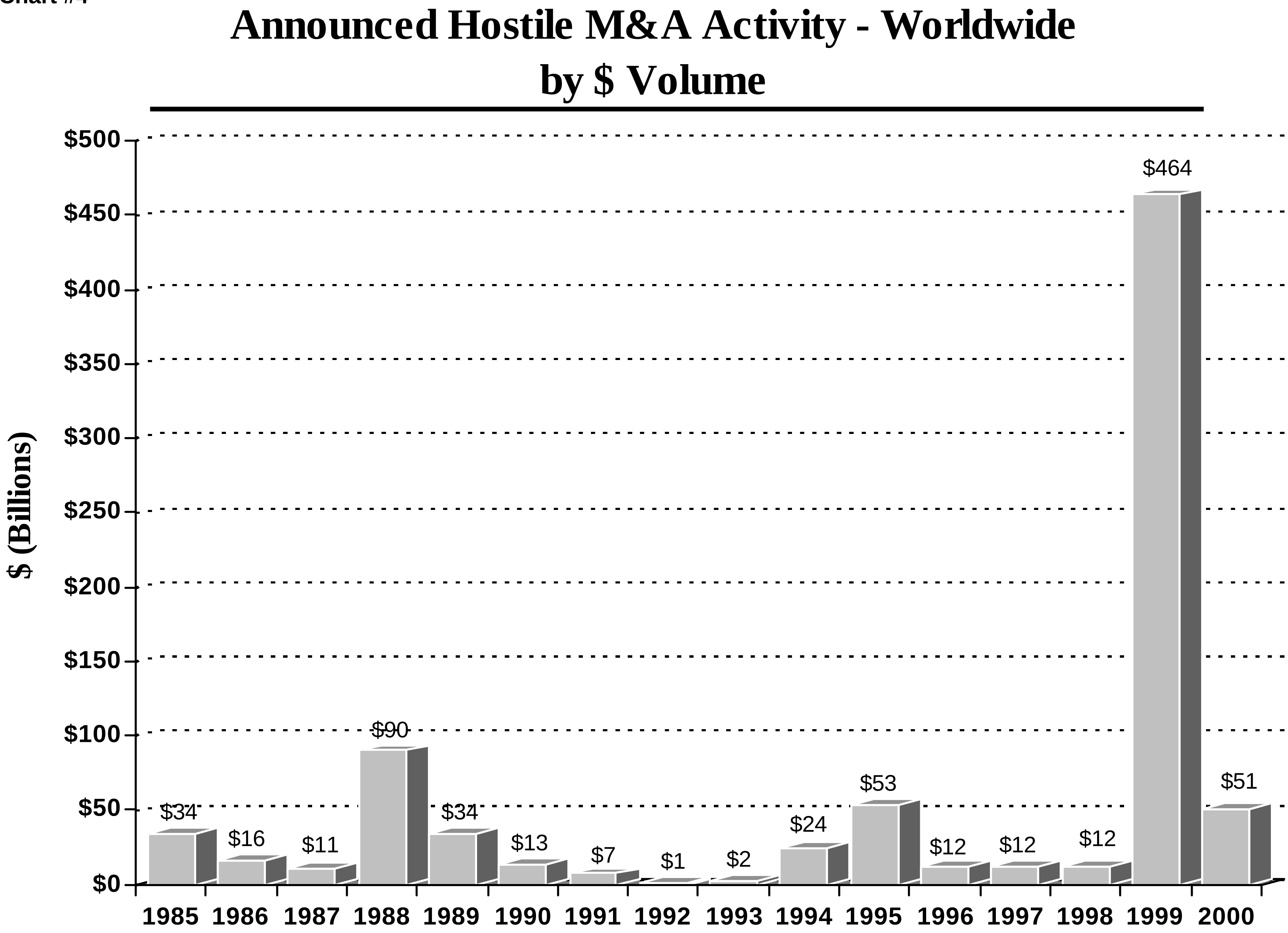
Chart #3

Announced Hostile M&A Activity - U.S. Domestic by $ Volume



Source: Thomson Financial Securities Data

Chart #4



Source: Thomson Financial Securities Data

Chart #5

Top Ten U.S. M&A Deals

Date Announced	Target Name	Acquiror Name	Value of Transaction ($mil)
01/10/2000	Time Warner	America Online Inc	$164,746.5*
11/04/1999	Warner-Lambert Co	Pfizer Inc	$89,167.7
12/01/1998	Mobil Corp	Exxon Corp	$78,945.8
04/06/1998	Citicorp	Travelers Group Inc	$72,558.2
05/11/1998	Ameritech Corp	SBC Communications Inc	$62,592.5
04/13/1998	BankAmerica Corp	NationsBank Corp	$61,633.4
01/18/1999	AirTouch Communications Inc	Vodafone Group PLC	$60,286.9
06/14/1999	US WEST Inc	Qwest Communications Int'l Inc.	$56,307.0
07/24/2000	VoiceStream Wireless Corp	Deutsche Telekom AG	$53,877.7*
06/24/1998	Tele-Communications Inc	AT&T Corp	$53,592.5

Source: Thomson Financial Securities Data

* Pending

Chart #6

Top Ten Worldwide M&A Deals

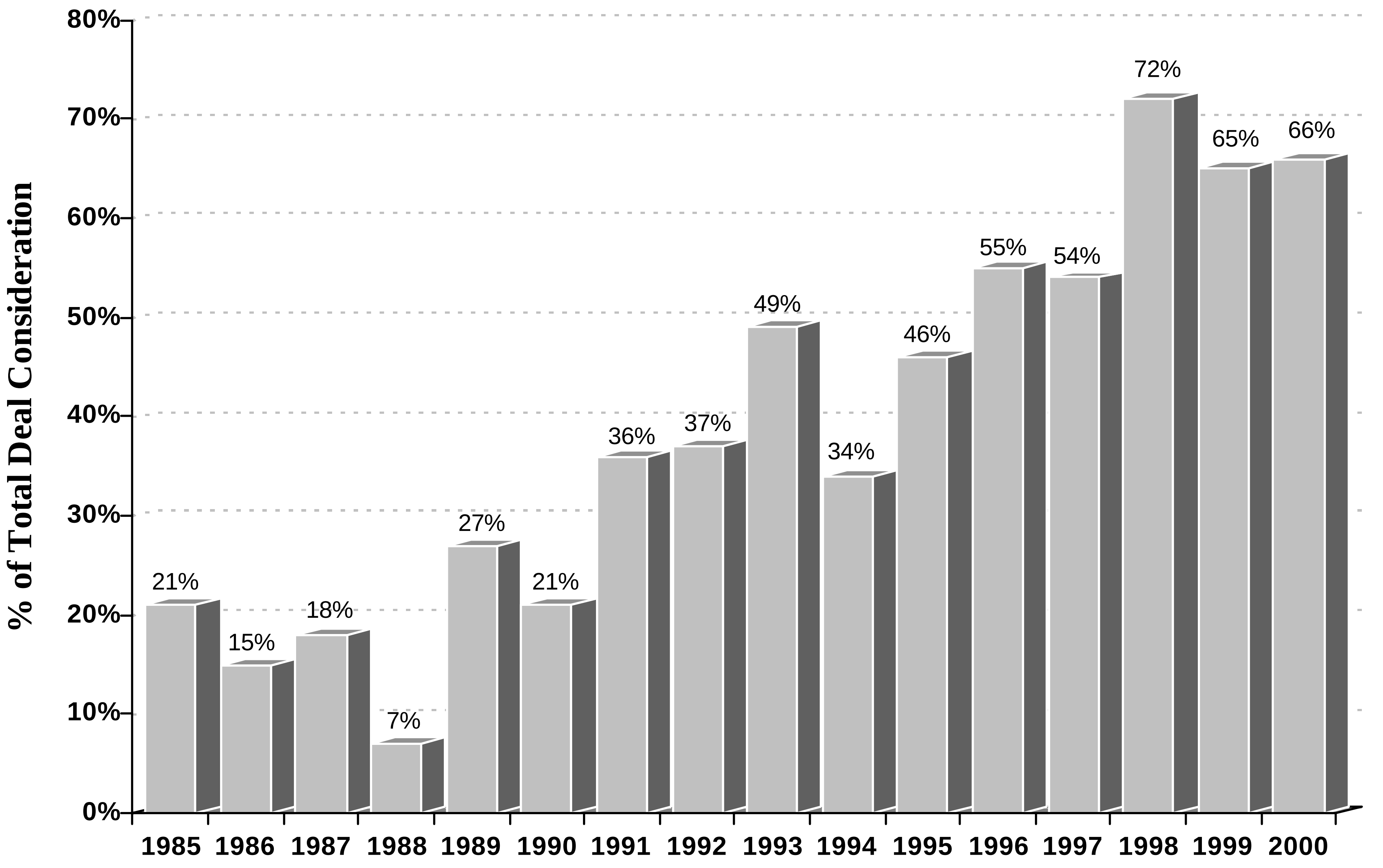
Date Announced	Target Name	Acquiror Name	Value of Transaction ($mil)
11/14/1999	Mannesmann AG	Vodafone AirTouch PLC	$202,785.1
01/10/2000	Time Warner	America Online Inc	$164,746.5*
11/04/1999	Warner-Lambert Co	Pfizer Inc	$89,167.7
12/01/1998	Mobil Corp	Exxon Corp	$78,945.8
01/17/2000	SmithKline Beecham PLC	Glaxo Wellcome PLC	$75,960.8
04/06/1998	Citicorp	Travelers Group Inc	$72,558.2
05/11/1998	Ameritech Corp	SBC Communications Inc	$62,592.5
01/26/2000	BankAmerica Corp	NationsBank Corp	$61,633.4
04/13/1998	AirTouch Communications Inc	Vodafone Group PLC	$60,286.9
01/18/1999	US WEST Inc	Qwest Communications Int'l Inc.	$56,307.0

Source: Thomson Financial Securities Data

* Pending

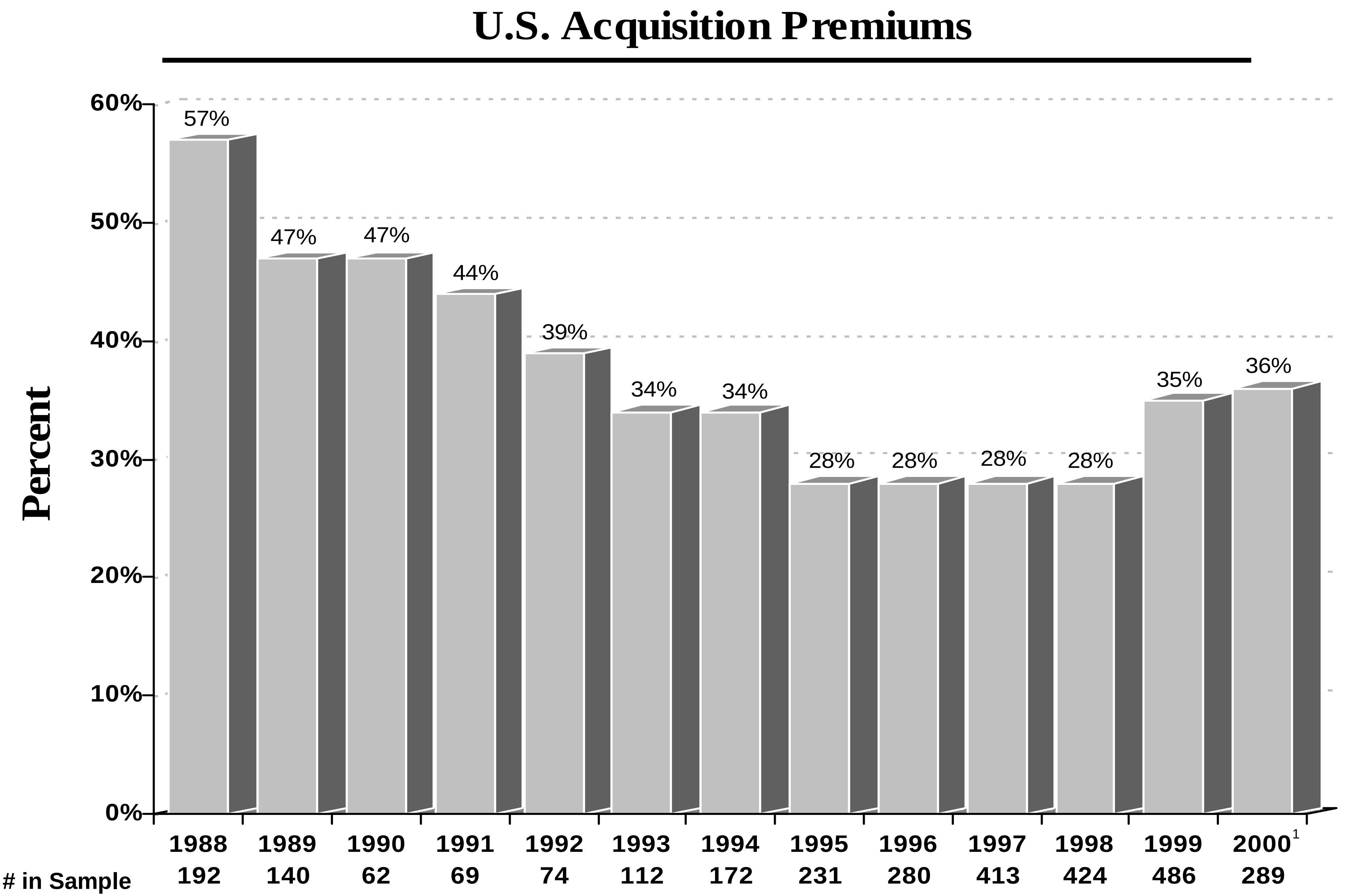
Chart #7

% of U.S. Deal Consideration Consisting of Stock



Source: Thomson Financial Securities Data

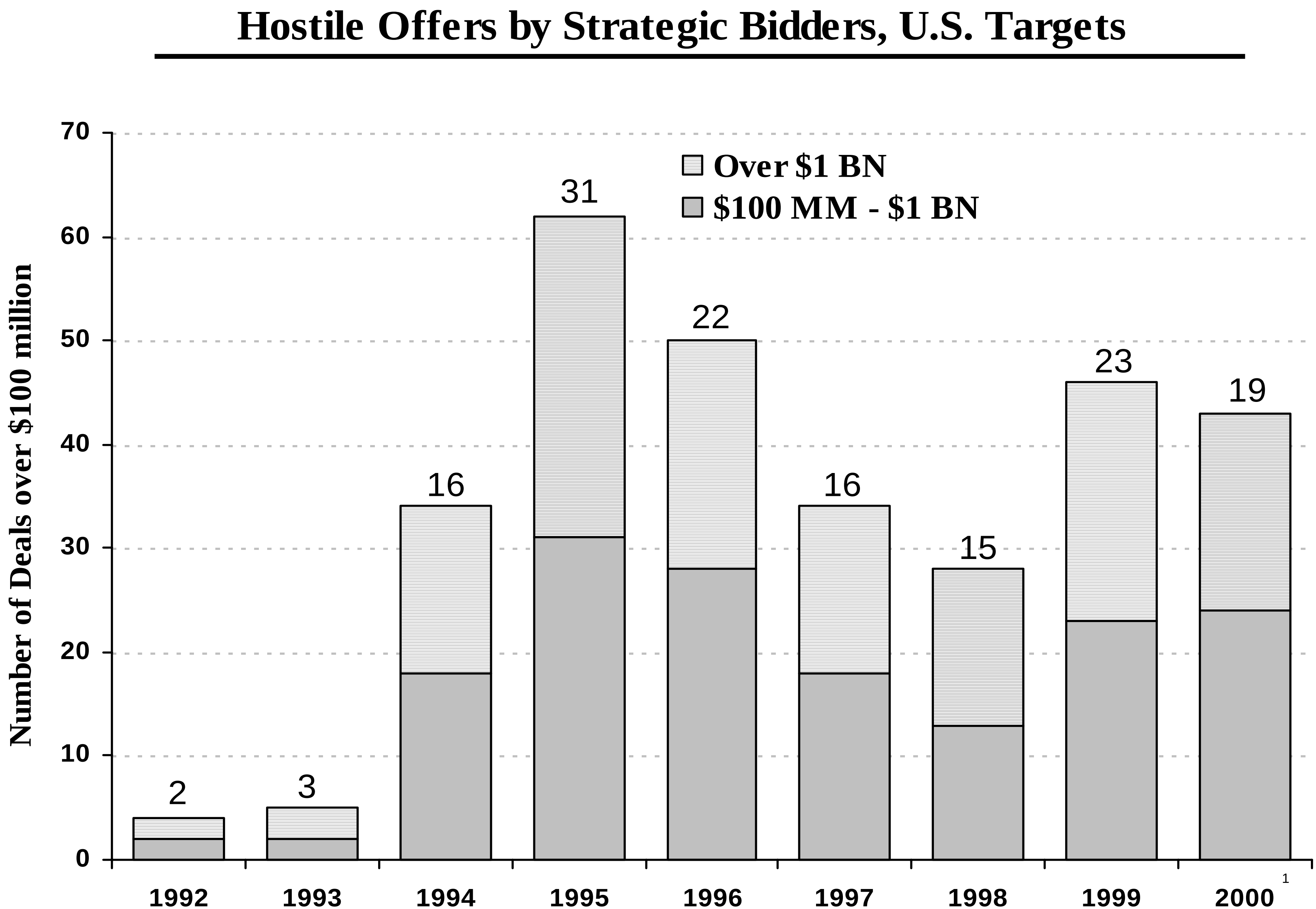
Chart #8



[1] YTD as of 9/30/00

Source: J.P. Morgan M&A Research, Thomson Financial Securities Data

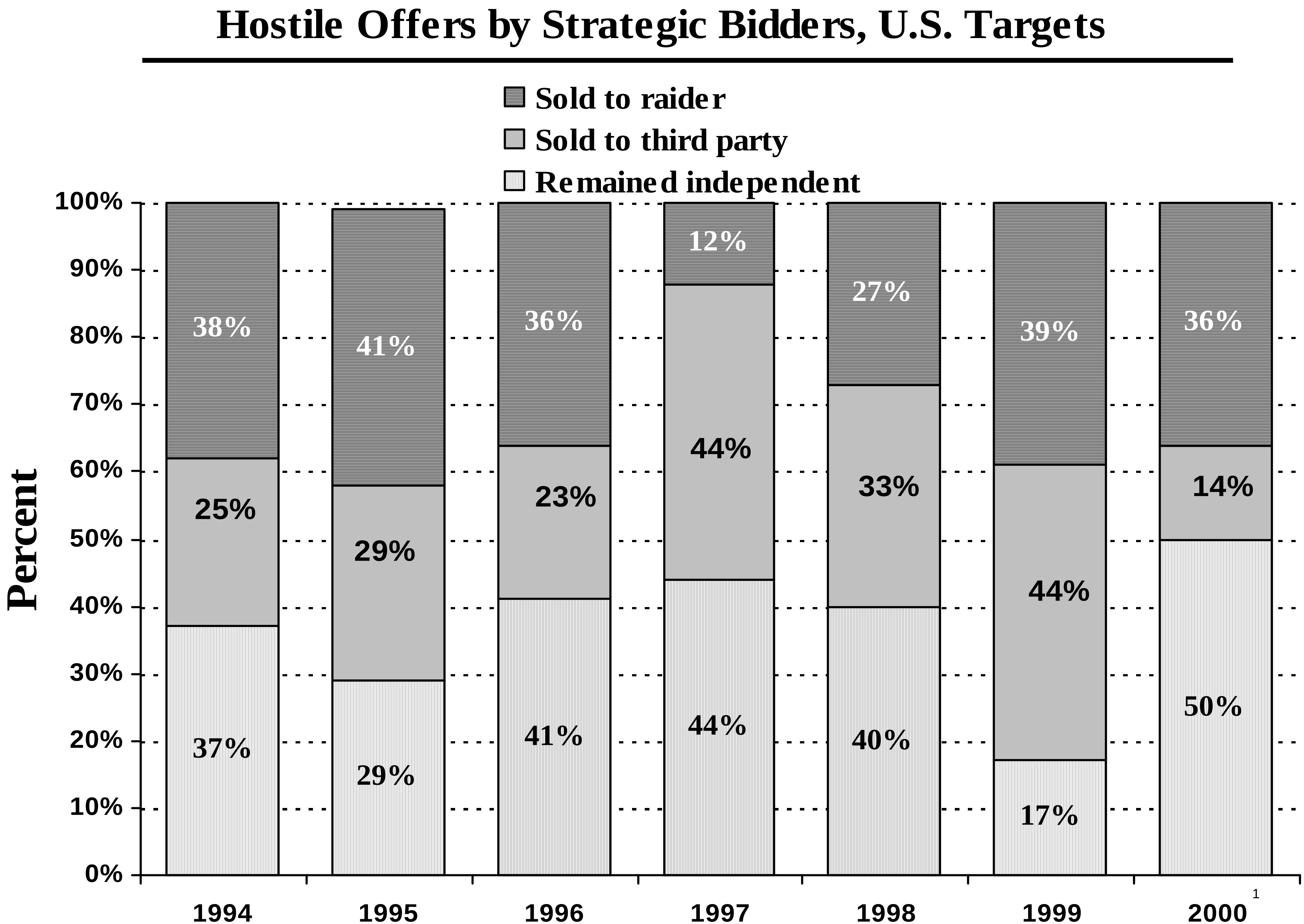
Chart #9



Source: J.P. Morgan M&A Research, Thomson Financial Securities Data

[1] YTD as of 9/30/00

Chart #10



Source: J.P. Morgan M&A Research

[1] YTD as of 9/30/00