CHAPTER 1

Merger Growth Strategy

Mergers and acquisitions (M&A) can accelerate a company's growth probably more than most other means within its arsenal. This is particularly true of larger deals. However, as we discuss, the track record of M&A success is spotty at best. The key is determining *a priori* the deals that will be winners and the ones to avoid. The problem is further complicated by the fact that management may sometimes seek to pursue M&A for their own personal benefit, which may work against the interests of shareholders.

As we discuss at length in this book, there is a large body of research on the effectiveness of M&A and the impact that M&A has on shareholder wealth. In fact, M&A is one of the most researched topics in the field of finance. There is a large body of high quality pragmatic studies that scrutinize M&A decisions and the impact they have on the shareholders. These researchers, primarily academics, have devoted considerable time and effort to trying to determine the answers to questions such as "Do diversifying deals or M&A outside of a company's established expertise have positive or negative effects on the wealth of their shareholders?" This is one example of an important question that M&A decision makers could answer better if they were aware of the relevant research. However, one of the surprising facts of the field of M&A is that decisions makers, CEOs, and their boards of directors, generally have no awareness of this large body of quality research and make no effort to try to look into it further. As we discuss throughout this book, the answer sometimes lies in the fact that they have their own agenda and are not interested in uncovering facts and evidence that would not be supportive of that agenda.

We explore the different kinds of M&A with an eye toward determining which ones work better than others. The unfortunate part of M&A, though, is that so much of the *strategy*, ironically, does not appear to be very strategic. There is a troublesome volume of major M&A that make you want to scratch your head and wonder how could these deals really be based on a well-thought-out strategy. Unfortunately, it seems clear that many of them were based on motives other than the furtherance of shareholder wealth. Indeed, some of them, such as the Citigroup one-stop-shop financial supermarket that was formed in the years prior to 2000, clearly did not serve consumers or shareholders. In fact, it mainly served Citigroup's CEO Sandy Weill's ego and bank account.

STRATEGY AND M&A

As we reiterate in Chapter 2, companies need to develop a growth strategy. Historically, the bulk of the return on equities comes from capital gains not dividend income. For there to be capital gains, the earning power of the company needs to rise. In other words, there should be growth. Therefore, companies need to create a strategic plan for how they are going to achieve such growth. Only secondarily do we inquire if M&A can facilitate that strategy. Sometimes it will be clear that M&A will play an integral part in the path to growth. In other instances, it may play only a minor role or no role at all.

The problem with many M&A is that sometimes they clearly are not a part of a well-thought-out strategic plan. Some seem haphazard such as deals that come up when dealmakers, such as investment bankers, approach a company with a brilliant idea that will make the bankers money but may have questionable value for the buyer. While such non-strategic motivations may be responsible for many M&A failures, there is reason to believe that most M&A do have some kind of a strategic basis even though that basis may be questionable. As an example, we consider the highly questionable M&A history of American Express in the case study that follows.

CASE STUDY: AMERICAN EXPRESS AND ITS STRANGE M&A HISTORY

We are all very familiar with American Express. It is the world-renowned credit card company that has enjoyed decades of success in the industry. In fact, the company can trace its roots back to the mid-1880s. However, like so many companies, it was unsatisfied with its great success in the business that it excelled at—credit cards—and aspired to broaden its reach into areas where it possessed no expertise at all. In 1981, American Express acquired the major brokerage firm Shearson Loeb Rhoades for $900 million ($3.3 billion in 2013 dollars). Shearson was the second-largest U.S. brokerage firm after

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Merrill Lynch and was crafted by CEO Sandy Weill through a series of 15 different M&A.

One has to wonder what could be the commonalities between credit cards and buying and selling shares of stock and bonds? Could it possibly be that when you call Shearson for a stock purchase you tell the broker "please charge it on my AmEx" and then perhaps you would get a discount for keeping it all in the family? Not really.

Undaunted at this absurd combination, American Express went out to create a financial supermarket—a one-stop company that markets a variety of financial services. In fact, that would not be the only major financial services company to try to create a financial supermarket that consumers did not want. Citigroup would outdo them years later.

In 1984, American Express acquired the investment bank Lehman Brothers for $360 million ($1.12 billion in 2013 dollars). Now, we have to wonder what these synergies could be? Perhaps someone who has a credit card with American Express could call up the Lehman Brothers unit and ask could they underwrite an offering of bonds and perhaps put that as well on his or her AmEx card? We can see there may be, and I mean *may* be, some synergies between the brokerage operation and the investment banking business. The reason why we say *may be* is that the tension between these two units would cause a great deal of consternation at Lehman years later where Lew Glucksman, from the rougher brokers' side of the business, forced out the investment banker Pete Peterson for the leadership of the firm. Peterson went on to be the very successful founder of the Blackstone Group while Lehman would eventually fall into bankruptcy under the leadership of Glucksman's protégé Dick Fuld.

Not a company to leave bad enough alone, in 1984, American Express went on to buy the Ameriprise financial planning business. Again, all the businesses involve money in some way so perhaps that would be the source of the synergy? It did not work out that way.

In 1988, the brokerage firm E.F. Hutton merged with Shearson Lehman, and the name was changed in 1990 to Shearson Lehman Hutton. This became the largest brokerage firm in the United States. In 1993, Shearson was sold to Primerica (Sandy Weill) for $1.15 billion. In 1994, American Express then spun off Lehman Brothers but not before it had to inject $1.1 billion to keep it viable. This is a business it acquired roughly a decade earlier for $360 million. Clearly American Express was great at running a credit card business but terrible at strategic planning and M&A.

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The company would hold on to Ameriprise, a financial planning business that was a combination of different financial planning and asset management businesses, starting with its acquisition of IDS Financial Services from Alleghany Corporation in 1984. American Express owned this business for years, and actually added to it through other acquisitions, such as London-based Threadneedle Asset Management Holdings in 2003, even though it also offered no synergies. In 2005, American Express spun it off but not before it had to give Ameriprise a $1 billion infusion. While this is clearly terrible M&A planning, there have been even worse deals.

INTRODUCTION TO M&A

The field of M&A has grown greatly over the past half century. At one time M&A was mainly a U.S. phenomenon but starting in the fifth merger wave of the 1990s, M&A volume in Europe rivaled that of the United States. When we say that the United States was for many years the leader in M&A, this should not be construed to be as a good thing necessarily. While some M&A deals are great, there are all too many that are outright terrible.

By the 2000s, M&A had become a commonly used corporate expansion strategy for companies worldwide. By the 2000s, Asia, including rapidly growing China and India, had joined the ranks of the major participants in M&A. They have also been joined by South and Central American as well as Australian companies. Indeed, M&A is truly a global phenomenon.

While we have been mentioning just M&A, it is corporate control deals in general that have grown dramatically across the globe. These include M&A but also restructurings, such as divestitures and spinoffs. Indeed, one company's divestiture may be another's acquisition. Joint ventures and strategic alliances have grown comparably as well.

In this book, we analyze how M&A can be used to facilitate a company's growth. We will also see that an M&A can be a double-edged sword, which sometimes bestows great benefits and other times yields high costs and few benefits. The trick, so to speak, is to find out in advance which deals can help companies facilitate growth and which ones should be passed on. As the large number of merger failures will attest to, this is no easy task. For this reason, we spend almost as much time examining the causes of M&A failures as we do on the benefits from successful deals. Many of the failures have some common elements that should have enabled the dealmakers to identify them in advance. There is also a large body of very pragmatic and useful research that could help M&A decision makers, but all too often, they are totally unaware of this valuable knowledge base.

Before we begin such discussions, it is useful to discuss some general background information and cover the basic terminology we use throughout.

BACKGROUND AND TERMINOLOGY

A *merger* is a combination of two corporations in which only one corporation survives. The merged corporation typically ceases to exist. The acquirer gets the assets of the target but it must also assume its liabilities. Sometimes we have a combination of two companies that are of similar sizes and where both of the companies cease to exist following the deal and an entirely new company is created. One of the classic examples of this occurred in 1986, when UNISYS was formed through the combination of Burroughs and Sperry. However, in most cases, we have one surviving corporate entity, and the other, a company we often refer to as the *target*, ceases to officially exist. For statistical purposes deals are recorded with the larger company being treated as the acquirer and the smaller one as the target—even when the two companies call it a merger.

Most M&A are friendly transactions in which two companies negotiate the terms of the deal. Depending on the size of the deal, this usually involves communications between senior management of the two companies, in which they try to work out the pricing and other terms of the deal. Along the way, the boards of each company track the progress of the negotiations. For public companies, once the terms have been agreed upon, they are presented to shareholders of the target company for their approval. Larger transactions may require the approval of the shareholders of both companies. Once shareholders approve the deal, the process moves forward to a closing. Public companies have to do public filings for major corporate events, and the sale of the company is obviously one such event that warrants a filing by the target.

HOSTILE TAKEOVERS

While most deals are friendly in nature, some are outright hostile takeovers. The hostile takeover started to become popular in the 1980s during the fourth merger wave—a period known for its colorful hostile deals and also for the many leveraged buyouts that took place. While we had hostile deals for many years in the United States prior to the fourth merger wave, it was during that time period that hostile takeovers of major companies became more common.

In addition, it became acceptable for major companies as aggressors to embark upon such bids. Today, these types of transactions are common all over the world.

Hostile takeovers refer to the taking control of a corporation against the will of its management and/or directors. Taking over a company without the support of management and directors does not necessarily mean it is against the will of its shareholders. The way the takeover process works, shareholders usually do not get to express their views directly during a takeover battle and rely on management to do this for them. The situation may be different if the company has some large aggressive shareholders such as hedge funds. Such large investors are in a better position than smaller shareholders to get management and the board of directors to listen to their views on the deal. It may even be the case that the hedge funds are the one pushing the deal forward—possibly even in opposition to management. They may do this if they believe that current management is not optimizing the value of the company and that the quickest way to enhance the firm's value is to put it up for sale.

The main reason why a bidder pursues a hostile, as opposed to a friendly takeover, is that the deal is opposed by the target's management and board. Bidders usually want to do friendly deals because hostile deals typically are more expensive to complete. The greater expense comes from the fact that the bidding process may result in a higher premium as other bidders push up the price. It also may mean that the bidder has to keep raising the price to overcome the target's resistance. Hostile deals also may increase investment bankers' fees and legal costs. For the bidder, going hostile means that there is less assurance that a deal will go through compared to friendly deals, which have a much higher percentage of completion.

One of the main tools used to complete a hostile takeover is the *tender offer*. Tender offers are bids made directly to shareholders, bypassing management and the board of directors. If a company were pursuing a friendly deal, the logical place to start would be to contact the target company management. If this contact is rejected, then there are two other alternatives: (1) go to the board of directors or (2) go directly to shareholders. When bidders make an offer directly to the board of directors, this is sometimes referred to as a *bear hug*. It is mainly a hostile tactic because it carries with it the implied, and sometimes stated, threat that if the offer is not favorably received, the bidder will go directly to shareholders next.

If a friendly overture or a bear hug is not favorably received, then one of the next alternatives is a tender offer. Here the bidder communicates the terms of its offer directly to shareholders, hoping they will accept the deal. In the United States, the Williams Act (1968), a law that was an amendment to the Securities Exchange Act of 1934, provides specific regulations to which tender offers must adhere. Bidders cannot immediately purchase shares that are tendered to them but have to wait 20 days. During the 20-day offer period, other bidders may make offers. The first bidder may have put the target company *in play* and may then find itself in a bidding contest. Target company shareholders then get to consider both offers and possibly even others. This usually works to their advantage because they tend to receive higher premiums when there are multiple bids.

For bidders, however, it usually means they either will have to pay a higher price for the target or will have to drop out of the process. Shrewd bidders know where to draw the line and step back. Others, sometimes consumed by hubris, will bid on in an attempt to “win” the contest. Often what they end up winning is the *winner’s curse*, where they pay more than the company is worth. As we discuss in a case study in Chapter 11, this was the case in 1988 when Robert Campeau, having already acquired Allied Stores, went on to make an offer for Federated, which would give him the largest department store chain in the world. Unfortunately for him, Macy’s stepped into the bidding process, and CEOs Edward Finkelstein and Robert Campeau went head-to-head, increasing the premium until finally Campeau “won out.” The ultimate winning bid was $8.17 billion (equity, debt, and total fees paid), but the acquisition saddled the combined company with billions of dollars in new debt. Unable to service the debt, and unable to sell off units at favorable prices in an M&A market that sharply cooled after the completed the deal, Campeau was forced to file for Chapter 11 bankruptcy not that long after the successful completion of the takeover. As we will see, this is not an isolated incident. All too often tightly fought bidding contests force takeover prices too high thereby eliminating the chance to realize net gains from the takeover.

A deal that may have been a good strategic fit can become less appealing if the offer ends up being a hostile takeover. If the process turns hostile, the bidder may (not always) end up overpaying. This may create a situation where the higher price offsets the initially perceived strategic value. If this is the case the bidder needs to back away and adjust the strategy. What is a “good” strategic fit at one price can be a bad one at another.

Another alternative to a tender offer is a *proxy fight*. This is where the bidder tries to use the corporate democracy process to garner enough votes to throw out the current board of directors and the managers they have selected. They would either try this at the next corporate election or call a special election. The *insurgent*, as such bidders are now called in this context, then presents its proposals and/or its slate of directors in opposition to the current group. In the 2000s, proxy battles became a popular method used by hedge funds to bring about changes in companies they had amassed stakes in. Such hedge funds would seek out undervalued targets, which they believed could benefit from specific changes such as replacing management, using cash for larger dividend payments, selling off assets, and so forth. Often the goal of hedge funds is not to take over a target but to enable them to realize short-term gains on their investment.

When a proxy fight is used to facilitate a takeover, bidders often find that it is a costly and uncertain process. It is often unsuccessful, although again, success depends on how you define it. If the bidder is trying to bring about changes in the way the target company is run, this process often does accomplish that. For hedge funds, such changes might be selling off assets or even an outright sale of the entire firm. If the goal, however, is to get shareholders to outright reject the current board and then go so far as to accept a bid for the company against management's recommendation, then this process often does not work. That is, bidders also find themselves having to expend significant sums for an outcome that often does not work in their favor—at least in the short run. Hedge funds, though, have been enjoying some success in acquiring equity positions in undervalued companies and then agitating to bring about changes that will uplift the value of their, and other shareholders', equity investments. In fact, in the 2000s, many hedge funds specialize in this activity. At times these hedge fund strategies can work to be benefit of shareholders who find themselves stuck with an overpaid and intransient management who are unwilling to make necessary changes to uplift shareholder values.

TAKEOVER DEFENSE

The hostile takeover process is somewhat like a chess match, with the target company being pitted against the hostile bidder. The methods used became much more sophisticated in the fourth merger wave of the 1980s, when hostile takeovers suddenly became commonplace. Targets, while initially slow to respond with effective defenses, eventually developed somewhat effective means of thwarting some bidders and extracting greater gains for their shareholders from others. We are now a quarter of a century after that fourth merger wave and many of the tactics developed in that period remain close to being state-of-the-art. Moreover, the laws, including case laws, have refined which techniques are legal and which are not. Many of the laws regulating defensive and offensive hostile takeover methods, which originally developed in the United States when M&A was mainly a U.S. phenomenon, have been copied and adapted into the securities laws of nations all across the world.

There are two types of takeover defenses. *Preventive takeover defenses* are put in place in advance of any specific takeover bid. They are installed so that the bidder will not attempt a takeover. *Active takeover defenses* are deployed in the midst of a takeover battle where a bidder has made an offer for the company. Although there are a variety of both types of defenses, many of them are less effective than when they were initially created.

The most effective preventive takeover defense is a *poison pill*. Poison pills are also called *shareholders' rights plans*. Rights are short-term versions of warrants. Like warrants, they allow the holder to purchase securities at some specific price and under certain circumstances. Poison pills usually allow the rights holders to purchase shares at *half-price*. This is usually worded as saying the holder can purchase $200 worth of stock for $100.

Poison pills are an effective defense because they make the costs of a takeover very expensive. If the bidder were to buy 100 percent of the outstanding shares, it would still have to honor the warrants held by the former shareholder, who would then be able to purchase shares at half-price. Because this usually makes an acquisition cost prohibitive, bidders seek to negotiate with the target to get it to dismantle this defense. Sometimes the bidder makes direct appeals to shareholders, requesting them to take action so they can enjoy the premium it is offering, which management and the board may be preventing them from receiving. Target management and directors, however, may be using the protection provided by the poison pill to extract a suitable premium from the bidder. Once a satisfactory offer is received, they may then dismantle this defense. This can usually be done easily and at low cost to the target company.

Corporate governance advocates have put pressure on companies to remove their poison pills. They are concerned that companies use this potent defense to insulate management from the corrective pressure of the takeover market. This is why in the 2000s, many companies chose to not renew these plans, which often are in effect for 10-year periods. The other reason is that these same companies know that if they needed to they could implement a new one in very short order. For example, Netflix did just that in November 2012, when Carl Icahn's presence as a 9.9 percent shareholder became a cause of concern for them.

Other types of preventive takeover defenses involve different amendments of the corporate charter. One such defense is a staggered board, which alters the elections of directors so that only a limited number of directors, such as one-third, come up for election at one time. If only one-third of the board could be elected at one time, then new controlling shareholders would have to wait for two elections before winning control of the board. This hinders bidders who make an investment in the target and then cannot make changes in the company for a period of time. Such changes may be a merger with the bidding company or the sales of assets, which might be used to help pay off debt the bidder incurred to finance the acquisition of the target's stock. Today these kind of boards are less common than they were years earlier.

Other common corporate charter amendments are supermajority provisions, which require not just a simple majority but a higher percentage, before certain types of changes can be approved. If a group of shareholders will not vote with the bidder, such as managers and some employees who are worried about their jobs, then a bidder may not be able to get enough shares to enact the changes that it needs to take full control of the company.

Other corporate charter–based defenses include dual capitalizations. These feature different classes of stock, which afford different voting rights and dividend entitlements to holders of the shares. They often involve one class of super voting rights stock, which usually pay very low dividends. These shares are usually distributed to all shareholders, but those who are interested in augmenting their control, such as managers, may retain it while others may accept a follow-up offer by the company to exchange these shares for regular voting and dividend-paying stock. The end result of such a stock offering/dividend distribution is that increased control is concentrated in the hands of shareholders who typically are more *loyal* to the corporation and who would be less likely to accept an offer from a hostile bidder. The Securities and Exchange Commission (SEC) and stock exchange rules limit the extent to which companies can issue and trade such shares.

A target company can take several steps when it is in receipt of an unwanted bid. Drawing on the defense that has been used for many years, it could file a lawsuit. Unless there are important legal issues it could argue, this often is not enough to stop a takeover. It may, however, provide time, which may enable the target to mount other defenses. This may include selling to a more favored bidder—a *white knight*. It may also involve selling shares to a more friendly party. This can be done in advance of an offer or as an active defense. The buyer in such sales is referred to as a *white squire*.

Targets may also restructure the company to make it less attractive to a bidder, or it may make some of the same changes that are being suggested by a bidder, thereby taking this recommendation away from the bidder. Restructuring the company may involve both asset sales and purchases. The company may also restructure its capitalization to increase its debt, making it more leveraged. Capital structure changes may have some impact by making the company less attractive and by reducing the amount of debt that can be raised by a bidder to finance the target's own takeover.

LEVERAGED TRANSACTIONS

Leveraged deals are those that use debt to finance takeover. They are sometimes referred to as highly leveraged transactions (HLTs). One well-known version of HLTs is a leveraged buyout (LBO). An LBO is an acquisition that uses debt to buy the target's stock. When people refer to an LBO, however, they are often referring to a transaction in which a public company is bought using debt and then is taken in private. For many years the largest LBO of all time was that of RJR Nabisco in 1988 for $24.8 billion. Using a 2.8 percent annual inflation adjustment factor this equates to just under a $50 billion deal in 2013 dollars!

RJR Nabisco was bought by the well-known buyout firm of Kohlberg Kravis and Roberts (KKR). Although many of KKR's deals have been successes, this buyout was not part of that notable group. This was the case for many reasons including overpaying, as well as not being able to anticipate the changes in the economic climate—even though these changes, such as economic expansions coming to an end after a certain time period, are the norm. The takeover was, nonetheless, quite colorful and became the subject of a successful book and movie.[1]

One of the risks that LBOs in general have is that the buyer takes on substantial debt, which leaves the company with a high degree of financial leverage. This carries with it all of the risk that high financial leverage imposes. This comes in the form of fixed charges for the increased debt service. Buyers of companies in leveraged transactions often plan on reducing this leverage with asset sales where the proceeds from those sales can be used to pay down the debt and reduce the debt service. In Robert Campeau's leveraged takeover of Federated Stores, the market soured after the acquisition and he was not able to sell off divisions at prices that reflected the value he paid when he overpaid for the overall company using borrowed funds whose debt he could not continue to service. Not overpaying is one key to takeover success. Related to that, avoiding bidding contests and overly hostile deals, which often cause the bidder to come away with the *winner's curse*, is also very important.

One of the other ways to reduce the pressures imposed by the debt incurred in an LBO is to implement cost structure changes and increased efficiencies, which will lower the company's overall costs and enable it to service the debt. Even here there may be problems. If a company sacrifices needed capital expenditures to reduce costs, such as what Campeau had to do and what Sears/Kmart did after their combination, this leaves the company in a weakened competitive position.

Buyers of companies in LBOs usually have a plan to reduce the debt over a period of time while they make various changes at the company. Many of these dealmakers plan on doing a *reverse LBO* sometime after the original LBO. In a reverse LBO, the private company that was bought out in the LBO goes public again. This can be done all at once or in stages, as it was done in the case of RJR Nabisco. In the RJR Nabisco deal, KKR sold percentages of the company to the public and used these proceeds to pay down the mountain of debt it had assumed. One of the reasons why this deal was not a success has to do with the bidding contest that occurred as part of the buyout. RJR received a lowball offer from a group led by then CEO Ross Johnson. KKR entered the fray with its own offer, knowing that the Johnson group's offer was low. However, a bidding contest ensued, and KKR won, but it really bore the winner's curse.

The winner's curse that the RJR Nabisco bestowed on its buyers was nothing compared to what became the largest LBO of all time—the 2007 $43 billion acquisition of electricity provider TXU by KKR and TPG Capital. This was a commodity-based business that was greatly affected by the price of natural gas, which, in turn, was greatly depressed by the glut of natural gas that came on the U.S. market after the LBO. It is amazing that we have this very famous private equity firm, KKR, pursuing these big mega-LBO flops. It is equally amazing that they, and another famous private equity firm, TPG Capital, did not consider that maybe a company that could be greatly affected by volatile commodity prices would not be a good candidate for great leverage and the high fixed payments that such debt requires.

Reverse LBOs are quite common following private equity LBOs. Private equity buyers acquire what they consider to be undervalued targets. They then seek to "flip" them—but only after they have extracted whatever gains they can such as through what are called dividend recapitalizations. When these buyers sell the acquired entity it is sometimes hard to find one buyer willing to pay a higher price than the private equity buyer did—especially after the private equity owners may have loaded the company up with debt and then used the debt proceeds to pay themselves dividends—what is known as *dividend recapitalizations*. When they cannot sell the now debt-laden company to one buyer, they often unload it to the market in an IPO. IPO buyers tend to be more naïve then other buyers—such as other private equity firms. Anyone unsure of the naïveté of IPO buyers need only think back to the Facebook IPO for confirmation.

RESTRUCTURINGS

Mergers and acquisitions are but one form of corporate restructuring. One form of restructuring that is the opposite of M&A is sell-offs. In a *sell-off*, a company sells part of itself to another entity. This can be done in several ways. The most common way is a divestiture, where a company simply sells off part of itself to another entity. However, downsizing can be accomplished in other ways, such as through spin-offs, where parts of a company are separated from the parent. Shares in the spun-off entity are given to shareholders of the parent company, who then become shareholders in two, as opposed to one, company. We discuss these types of transactions in Chapter 10 because they can be a way of *reversing the error*. Another way that a division of a parent company, perhaps one that was acquired in a deal that is now being viewed as a failure, can be separated from the parent company is through an equity carve-out. Here shares in the divisions are offered to the market in a public offering. In Chapter 10, we discuss the shareholder wealth effects of these different types of transactions. However, we can point out now that, in general, the shareholder wealth effects of these various forms of downsizing tend to be positive. A careful review the research convincingly reveals this to be true over an extended time period.

Another form of corporate restructuring on which we do not focus in this book but which is related to the world of M&A is restructuring in bankruptcy. Bankruptcy is not just an adverse event in a company's history that marks the end of the company. There are various forms of bankruptcy, and some of them are more of a tool of corporate finance where companies can make changes in their operations and financial structure and become a better company. Such restructurings can come through a Chapter 11 filing. The Chapter 11 filing refers to the part of the U.S. Bankruptcy Code that allows companies to receive protection from their creditors—an automatic stay. Other countries have bankruptcy laws that allow for restructuring, but many, such as Great Britain and Canada, are more restrictive on the debtor than the United States.

While operating under the protection of the bankruptcy court, the *debtor in possession*, as the company that did the Chapter 11 filing is called, prepares a reorganization plan, which may feature significant changes in the debtor company. These changes may provide for a different capital structure, one with less debt and more equity. It may also provide for asset sales, including sales of whole divisions, which supplies a cash infusion and may be used to retire some of the debt that may have led to the bankruptcy.

In the 1990s, many of the companies went through LBOs in the fourth merger wave, were forced to file for Chapter 11 protection. Returning to our Campeau Corporation example, it became a very different company after it emerged from bankruptcy protection. As with most Chapter 11 reorganizations, the equity holders, which included the dealmakers who dreamed up this highly leveraged acquisition, incurred significant losses as the market penalized them for their poor financial planning. Part of the focus of this book is to determine how such merger failures can be prevented. One of the options available for companies that have made poor deals is to proactively make some of the needed restructuring changes without having to go down the bankruptcy road. Sometimes, however, the situation is such that the pressure of the laws of the bankruptcy court is needed to force all relevant parties, including different groups of creditors who have different interests and motivations, to agree to go along with the proposed changes.

Bankruptcy presents many M&A opportunities. Shrewd bidders can find "great buys" in the bankruptcy process. This can be the case especially if the company is generally solid but has specific problems that can be remedied by the bankruptcy process. For example, if the company has valuable products and services and is only in bankruptcy due to too high leverage that was brought on by LBO artists, then this could be "fixed" in Chapter 11. Buyers in the Chapter 11 process may be able to acquire the valuable aspects of the company without the burden of all of its debt.

TRENDS IN MERGERS

Some volume of M&A always exists, but there have been several periods when a very high volume of deals was followed by a period of lower deal volume. These periods of intense M&A volume are referred to as *merger waves*. There have been six merger waves in the United States. The first merger wave occurred during the years 1897 to 1904. It featured many horizontal M&As. Many industries started the period in an unconcentrated state with many small firms operating. At the end of the period, many industries became much more concentrated, including some being near monopolies. This was ironic because the Sherman Act, as previously discussed, was specifically passed to prevent such an industry structure. The first wave ended when the economy and the market turned down. During the slow economy there was less pressure to do deals. This changed in the 1920s, when the economy started to boom. The vibrant economic conditions led to a second merger wave, which was concentrated during the 1916 to 1929 period. This wave featured many horizontal deals but also featured many vertical transactions. Deals were especially concentrated in specific industries. When the stock market collapsed in 1929 and the economy went into a prolonged and deep recession in the 1930s, the merger wave ended. We did not have another major merger period until the end of the 1960s. The decade of the 1950s was an up and down economy that had intense, if not absurd, antitrust enforcement.

The third merger wave was an interesting period in that it featured many conglomerate M&A because of the intense antitrust enforcement of that time period. The Justice Department was aggressive in its opposition to M&A and saw many deals, which would be approved immediately today, opposed on antitrust grounds. For this reason, companies that were acquisition-minded were forced to do deals outside of their industry to avoid the wrath of the Justice Department and the FTC—the two antitrust regulators in the United States. Many large conglomerates, such as ITT, LTV, Gulf & Western, Teledyne, and Textron were built during that period. While the 1960s featured a booming economy for much of the decade, both the economy and the market turned down at the end of the decade. Like the prior merger wave, it ended when the economic and financial pressures to expand subsided.

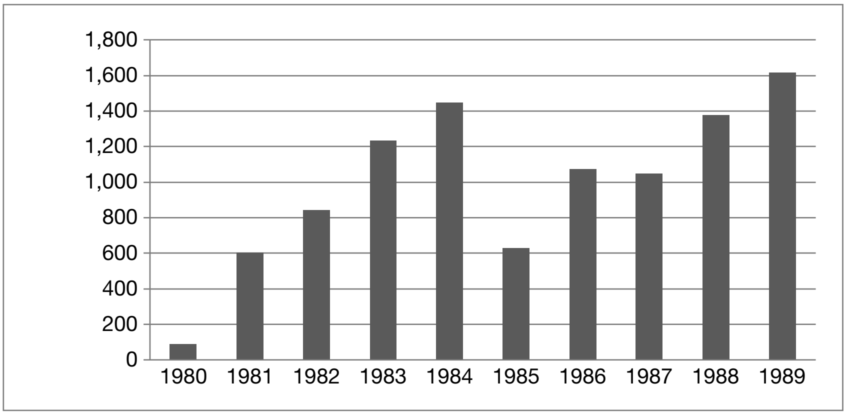
The 1970s featured a more modest number of M&As but did have many others forms of restructurings as companies, which may have been acquired during the third merger wave and were sold off as the firms adjusted to the slower economic conditions. Shareholders questioned some of the deals they had made when the economy was booming. The judgment of the company's managers may have been clouded by dreams of wealth that never materialized. As companies felt the economic pressures of a deep recession in the middle of the decade, they implemented management changes, and some of those changes helped bring about the various restructuring and sell-offs we saw during that period.

The 1980s proved to be the longest post-war economic expansion until we got to the following decade, which featured an even longer growth period. The 1980s provided the colorful fourth merger wave, which had many interested facets including the megamerger (see Figure 1.1). As noted earlier, some of these deals were highly levered and the fuel for these highly leveraged deals was provided by the junk bond market, which also boomed in response to the deal-related demand for this form of capital. The fourth wave also featured many hostile deals as companies, including major corporations, found themselves the target of unwanted suitors. Hostile bids certainly occurred before this period, but they were mainly offers by relatively smaller companies for other smaller companies. Before that period, it was unusual to hear of a hostile offer for large companies. It was even less common to have major reputable companies taking part in hostile takeovers. All of that changed in the late 1970s, and this set the stage for many of the hostile takeovers that occurred in the fourth merger wave of the 1980s.

The fourth merger wave ended when the economy slowed at the end of the decade and the junk bond market collapsed, in part as a function of weak economic conditions but also as a result of specific problems with that part of the bond market, including the indictment of Michael Milken and his investment bank—Drexel Burnham Lambert.

In 1990 to 1991, there was a mild recession in the U.S. economy, which recovered slowly initially and then with the rebound, picked up steam. As with many prior expansions, companies looked to grow, and the fastest way to expand is to buy whole companies as opposed to building such a business internally. To some extent, this makes sense as expanding economic

(a)



(b)

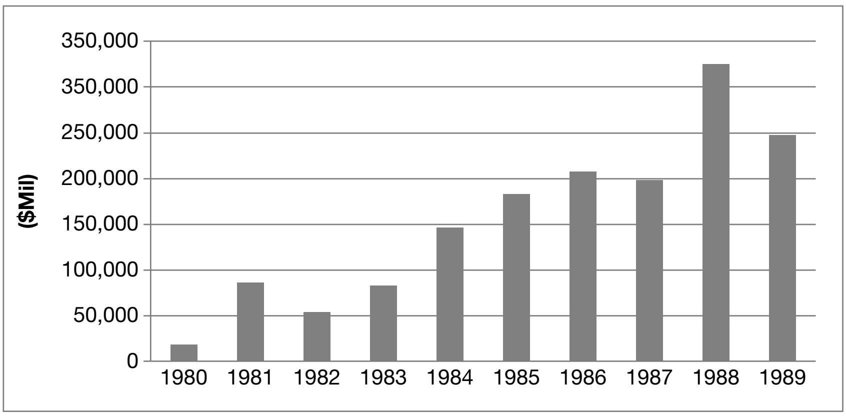


FIGURE 1.1 (a) Number and (b) Value of U.S. M&A in the 1980s
Source: Thomson Financial Securities Data.

conditions create market opportunities that companies may need to react to quickly in order to take full advantage. The problem occurs when dreams of economic riches cloud the judgment of management causing them to not make the most enlightened decisions. Another problem with booming economic conditions is that they can mask poor management. Increased demand can lead to higher sales and profits even for some companies that are not that well managed. When this occurs, shareholders and the board may credit management with gains that they did not bring about. This may lead them to go along with acquisition proposals that they may not scrutinize carefully enough. Management may get a pass, so to speak, until, for some of the less astute managers, their acquisition schemes blow up in their face. However, for those who made well-thought-out deals, they may be able to advance the company and take advantage of competitive opportunities in the marketplace.

The fifth merger wave was precedent-setting in terms of the total volume of mergers as well as the size of the deals that took place (see Figure 1.2). While many mega mergers took place in the fourth wave, some of the deals

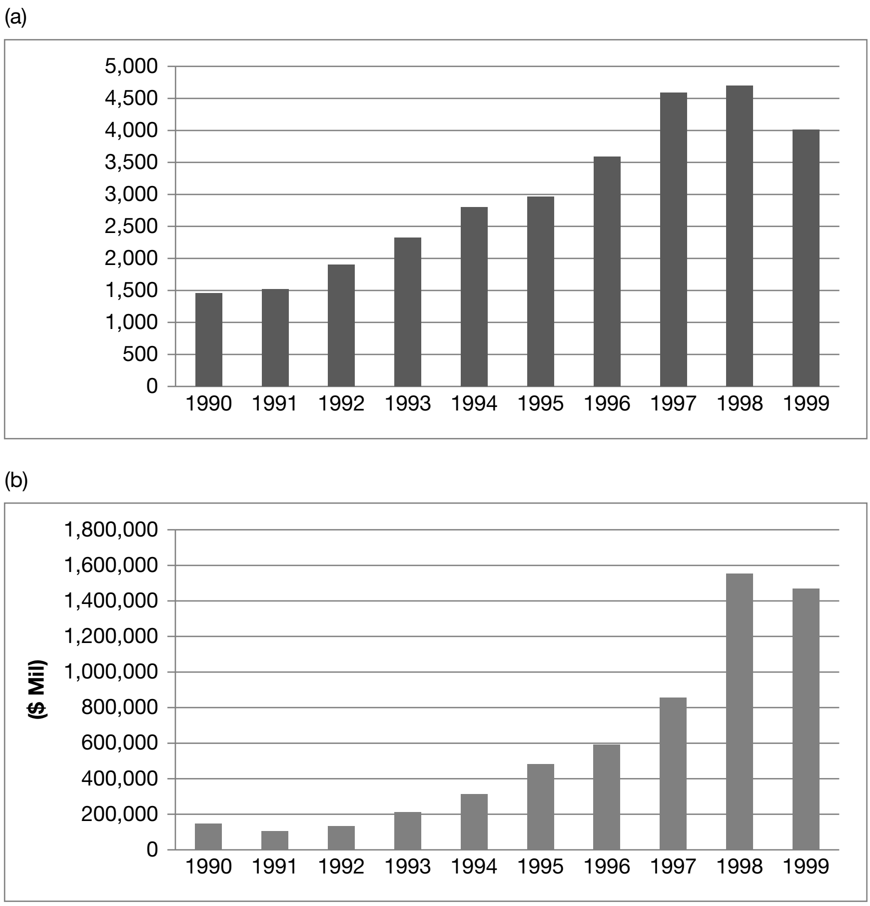


FIGURE 1.2 (a) Number and (b) Value of U.S. M&A in the 1990s
Source: Thomson Financial Securities Data.

that took place in the fifth wave made the fourth wave deals seem ordinary. Later in this book, we examine many of these leading deals that were simply flops—megaflops. M&A such as the AOL-Time Warner *merger of equals* were failures that left certain Time Warner shareholders incensed. Others, such as the Warner Lambert acquisition by Pfizer or the merger between Exxon and Mobil, clearly were major successes. The difference between successful and failed deals is discussed throughout the rest of this book.

The fifth merger wave was truly an international one with M&A volume in Europe rivaling that of the United States. The Europeans had drunk the American's M&A Kool-Aid and were off to the dealmaking races. In many ways, this was a needed change as for many years some very inefficient corporate structures had existed in Europe, and M&A was a way for these economies to create more efficient enterprises.

Like the merger waves that preceded it, the fifth merger wave ended when the economy turned down. Hot sectors such as the dot coms and the telecoms collapsed. However, like the 1990 to 1991 recession, the 2001 recession was relatively mild and only eight months in duration. The recovery was initially slow but low interest rates helped to boost certain sectors, such as real estate and construction, and a real estate bubble ensued. Alan Greenspan, the chairman of the Federal Reserve (Fed), basked in the glow of the praise bestowed upon him by those benefiting from the low interest rates he maintained. Not one to believe that one of his responsibilities as chairman of the Fed was to regulate lending in the country, he virtually ignored major producers of debt such as the mortgage lending industry. He also was a big supporter of deregulating banks, as he felt confident they would never engage in actions that would put these venerable institutions at risk. However, he did not understand human nature and did not realize that financial institutions are nothing more than a collection of individuals—all of whom have their own personal agendas. This agenda was to take advantage of the various short-term incentives that were in place to gain great wealth. And some of these individuals put their institutions, and everyone else around them, at risk. With the tacit support of Greenspan and the Fed, a financial system was created where certain employees can win big if they place big bets with other people's money and never have to give any of it back if later the bets don't work out.[2] In effect, the institutions become a casino—playing with house money. If some have scruples not to engage in such behavior, the competitive process will force them out to be replaced by less scrupulous people. All of this was beyond Greenspan's understanding, who to this day refuses to accept responsibility for his role in the subprime crisis.[3] The troubling aspect of this situation is that not a lot has changed in the years following the subprime crisis.

The subprime crisis and the Great Recession that followed brought an end to the sixth merger wave. After a short hiatus, deal volume continues at a

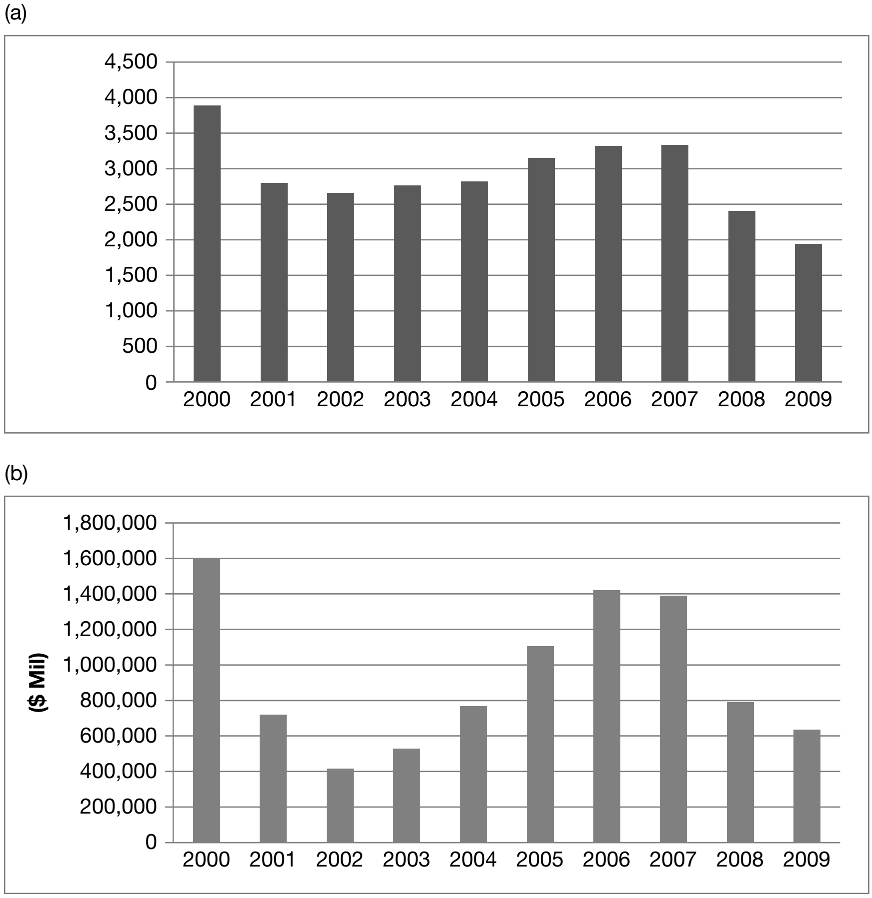


FIGURE 1.3 (a) Number and (b) Value of U.S. M&A in the 2000s
Source: Thomson Financial Securities Data.

good pace but featuring somewhat smaller deals (see Figure 1.3 (a)). Low interest rates make deal capital cheap even though the weak economic environment raises the risk profile of many deals. An intense M&A period has traditionally needed a robust economic and market expansion to take off. The weak U.S. recovery, followed by stagnation in Europe and weakness in China and much of Asia, has put a damper on M&A volume. Nonetheless, M&A continues, as it is an integral part of corporate growth strategy. This leaves us to explore how this strategy can be maximized.

NOTES

1. Bryan Burrough and John Helyar, *Barbarians at the Gate: The Rise and Fall of RJR Nabisco* (New York: Harper Trade, 1990).
2. William Fleckinstein and Frank Sheehan, *Greenspan's Bubbles: The Age of Ignorance at the Federal Reserve* (New York: McGraw-Hill, 2008).
3. Alan Greenspan, *The Age of Turbulence* (New York: Penguin Press, 2007).