MERGER MANIA

Take Two Lithium and Call Me in the Morning

Run out of ideas? Try a merger

By Irwin Stelzer

Another day, another billion-dollar merger. Or hundred-billion-dollar merger. Yawn. Time to turn the page to see how the Knicks are doing.

That's the reaction these days to even the largest of the mergers in the oil, telecommunications, automobile, pharmaceutical and electric utility industries. And with reason – three reasons, actually. First, there are just too many of these corporate marriages for any, save investment bankers or the most manic online investors, to track.

Second, the word "billions" has lost its shock value: there are simply too many gigabucks deals to elicit interest, much less awe. Indeed, investment bankers now categorize mergers in the $1 billion to $5 billion class as "mid-market." All in all, 1999 saw some $3 trillion in mergers, ahead of 1998's piddling $2.5 trillion. And it is probable that SBC Communications, which spent $72 billion for Ameritech last year, will not be the 1999 record-holder – not if Pfizer's bid ($80 billion) for Warner-Lambert goes forward.

Third, the reasons given by the public relations and financial relations experts who program their CEOs' appearances on CNBC are peculiarly unrevealing: We must get big to survive....In a globalized world we must be global….There are synergies to be had….The cost savings from this merger will be phenomenal.... Performance to follow (maybe). And never a mention of the fact that executive compensation is often influenced by the size of a company – especially if what economists call the psychic income provided by private jets, ski chalets and photo ops with world leaders is counted. Better to watch a good ball game than listen to these corporate executives trying not to explain what is behind their latest acquisition.

Very often, the goal of a merger is the unsurprising and not entirely laudable one of job retention. Having failed to improve a company's performance to the satisfaction of the board or key shareholders, an imperiled executive can put together a headline-grabbing deal that shows the time spent on the golf course was not in vain. Those contacts made at the 19th hole resulted in a merger that will "position the company for the future" – a sure sign that the executives involved would like you to forget the past.

Then, too, a merger can be management's very indirect way of acknowledging error – admitting that it has committed resources to an industry that suffers from excess capacity. Firms in declining industries can either shut the door and walk away – the deserted factory depicted in *The Full Monty* is not the only one of its sort – or they can merge with rivals and trumpet a cost-cutting campaign – a dignified way of shrinking an enterprise without admitting the dreary truth.

After all, write-offs and downsizing reveal to one and all that previous decisions to invest and hire were a mistake. Better to sell the company, report the cost savings that will result, bank a golden goodbye from the acquirer, and leave, reputation as a manager intact and as a deal-maker enhanced. And not have to answer the obvious question: if there were operational efficiencies there for the taking, why does it take a merger to realize them?

Viewed in this way, merger is an elegant strategy. Take the case of British Petroleum's acquisition of Amoco in 1998, a deal that was heralded as a means of saving billions by eliminating redundant facilities. Indeed, so great has been the attrition at Amoco after its acquisition by BP and a $2 billion cost-cutting exercise that the industry joke is: How do you pronounce BP-Amoco? Answer: The "Amoco" is silent.

Or consider the banking industry, also the scene of a wave of mergers by firms in an industry bloated with excess capacity and desperate to hold on to customers who are increasingly self-sufficient in the services they once bought from banks. Small customers find that ATMs that never close are more convenient than branches, and larger ones can go directly to the markets for capital without stopping at their friendly commercial banks. Mergers have proved to be a handy way of withdrawing capacity from the industry without moving stockholders from resentment to rebellion.

Then, too, many mergers stem from management's desire to "buy the future" – a future it has failed to position its company to prosper in. That may well be behind the merger craze in the pharmaceutical industry, where profits depend on the ability of companies to turn out a steady stream of new drugs, at least some of them in the blockbuster class. Seeing nothing in its lab that shows promise, a company may decide to buy the future product stream of a rival rather than do the decent thing – that is, to shrink and begin returning money to the shareholders, leaving the field to those more efficient at the business of research and development.

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A.T. Kearney, the management consultancy, estimates that drug companies that have merged have created less value for shareholders than those that have not, prompting *The Financial Times* to note recently "there is a profound paradox here. The creation of value… is central to share price performance.

And mergers, it seems, destroy value."

Even William Steer, the chairman of Pfizer, concedes that "most of the mergers we have seen have been made out of weakness." Not his bid for Warner-Lambert, he would argue, disagreeing with financial analysts who contend that Pfizer's move is a confession that, absent some acquisition, its growth prospects are dim. As *Business Week* put it in a recent survey of the industry's "frantic" merger activity, "even giants like Pfizer Inc. and Merck & Company don't have any obvious blockbusters in the wings."

This is not to pick on the oil, banking and drug industries. Or on mergers in general. For there are mergers and there are mergers. In the 1980's, when Michael Milken created junk bonds to finance takeover specialists, most high-profile mergers were hostile. Entrenched executives, grown fat on perks extracted from shareholders too fragmented to control their employee-managers, were displaced by debt-ridden entrepreneurs who had to become more efficient or find themselves unable to cover the interest payments on the bonds Milken and others had placed for them.

Such efficiency-enhancing hostile mergers still occur, but we are now in "A Slightly Kinder and Gentler Era for Hostile Takeovers," to borrow from a November 1999 *New York Times* headline. A mere 100 bids totaling $364 billion were in the "unsolicited" category last year, according to Thompson Financial Securities Data. With share prices at record levels, companies can use their stock as "currency" for deals of almost any size. And if the target company balks, it seems that some accommodation can be worked out these days.

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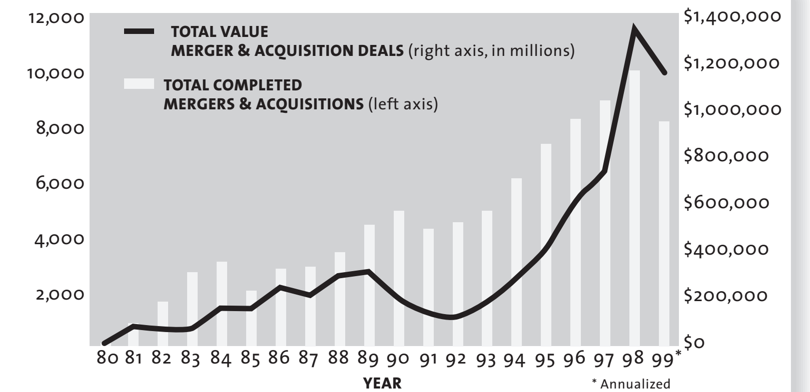
Perhaps the accommodation is the establishment of "co-CEOs," an invitation to infighting and to the eventual demise of one of these co-equal managers (think Travelers and Citigroup), often after a period of paralysis in which underlings expend their energies deciding which way to jump rather than figuring out how to enhance shareholder value. Not at all like the 1980's, when the deposed managers were not welcome in the executive suites of their former companies, and anyhow were unlikely to be willing to associate with what one of those corporate aristocrats termed "Diet-Coke-guzzling, cigar-smoking arrivistes."

There are other reasons why the shares of acquirers often sell down when a deal is announced, and why the owners of the acquired firm are delighted to take their premiums and run. Cultures clash. (Think Chrysler and Daimler.) Back-office computer systems collide rather than mesh. Foreign acquisitions prove to be a prelude to unexpected events: Brazil was the largest recipient of cross-border merger investment in the second half of 1998, according to investment bankers Robert Fleming. And the buyers of these Brazilian bargains apparently didn't factor in the risk that Brazil would have to let its overvalued currency sink to realistic levels.

Suffice it to say that two out of every three deals fail to create value. Only the selling shareholders walk away winners. Well, not quite: the acquiring CEOs know that bigger is indeed better – at least for them.

Of course, not all mergers are the result of base motives or prior mismanagement. And not all lead to cumbersome management structures. Some are responses to changes in economic circumstances so fundamental as to make the status quo untenable. The market for telecommunications services, for example, has become global in scope as deregulation and new technologies drive costs relentlessly down and the demand for more, better and newer services drives demand relentlessly up. Users of telecommunications services now operate around the globe and around the clock – and many want to deal with companies with the scale and scope to match.

HEADING FOR HIGHER AND HIGHER PLATITUDES



But whether mergers result from management greed, a mistaken reading of the economic tea leaves, or an accurate appraisal of the restructuring required by technology and changing regulations, one thing seems clear: most mergers create little threat to competition. For one thing, if the much-abused term "globalization" means anything, it is that most companies face vigorous competition from overseas rivals. No sensible trustbuster worries that the merger of Chrysler and Daimler-Benz has created a company capable of extracting monopoly profits from American consumers. If it tries to behave as if it possesses market power, the Daimler-Chrysler combo will find its customers wooed away, not only by domestic competitors such as General Motors and Ford, but also by foreign automakers such as Toyota, BMW and Volvo.

John Shenefield, former head of the Justice Department's antitrust division and now a senior partner in the law firm of Morgan, Lewis & Bockius, adds that the current relatively relaxed official attitude toward mergers is due to a realization that globalization and rapid advances in technology generally make it easier for newcomers to challenge incumbents. So the authorities worry less about concentration resulting from a merger, as long as there are no artificial barriers to the entry of new competitors.

But that does not mean the trustbusters are, or should be, passive. There are instances in which a merger can create concentration levels so high as to threaten competition, in which case selective disposals are demanded prior to the merger. And there are others where artificial barriers to entry – a limited number of takeoff and landing slots at an airport, to cite one classic example – warrant a challenge to mergers from the antitrust enforcers. But these are more the exception than the rule these days.

All this means that most mergers will, in the end, be tested in the market. Most of the conglomerates assembled in the 1960's have come unglued as they proved unable to compete with more focused companies. So, too, may many of the deals concocted in the 1990's, if size proves an impediment to the agility now needed to keep pace with accelerating change. And the discipline is likely to be swift and sure, if the trends toward more aggressive supervision by corporate boards and greater activism by institutional investors continue.

Not a bad policing mechanism, the free market. M