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Takeovers: Good or Evil?

In recent years, the pace of corporate takeovers has accelerated, surpassing even the feverish pace achieved in the "go-go" conglomerate merger days of the late 1960s. According to securities industry sources, 1985 may see the completion of over 2500 corporate combinations. Besides affecting the structure of the industries involved, takeover activity has had an important impact on debt markets since many takeovers are financed with borrowed funds.

For these reasons, many analysts are interested in the takeover phenomenon. Both Congress and regulatory agencies are increasingly concerned about the effects of takeovers on the corporate sector and the stability of the financial system. The purpose of this *Weekly Letter* is to examine briefly the rationale and implications of corporate takeovers. It appears that takeovers very likely perform a useful function in bringing new information to bear on the value of stocks and in imposing discipline on corporate management. But takeovers also generate risks for the lenders to such activities.

What is a takeover?

The terminology employed in discussions of corporate combinations is an unfortunate blend of formal economic, financial and journalistic terminology. In general, *friendly takeovers* might more properly be called *mergers* because the managements of the companies involved negotiate cooperatively to join their respective enterprises. A hostile or *unfriendly* takeover usually begins with a tender offer for the shares of a target firm by another corporation hostile or alien to the management of the target firm. The presumed goal in such hostile takeovers is to acquire sufficient control over voting shares to wrest management authority away from the target firm's current management. In a *self-tender,* extant management buys back outstanding shares from public shareholders; in the extreme, all shares are acquired and the firm "goes private." (In going private, tenders may be financed with borrowed funds secured by the firm's assets, in which case the term *leveraged buyout* also is used to describe the transaction.) In a *proxy fight,* groups of shareholders vie with management for changes in corporate policy by forming voting blocks or coalitions.

What all of these transactions have in common is that the extant management and/or its relationship to shareholders is changed. A merger or hostile takeover within an industry also changes the structure of that industry by joining formerly separate enterprises.

Takeovers and stock prices

To study the causes of takeovers, it is useful to review the events that take place in the course of a takeover, with a particular focus on the prices of the shares of the candidate and acquiring firms. Since share prices should reflect current and future anticipated returns to shareholders, they are a convenient barometer of the market's assessment of the takeover process.

A takeover may begin with a "silent" acquisition of shares by the acquiring firm or individual. If more than 5 percent of the outstanding shares of the target firm are acquired, the buyer must file Form 13D with the SEC, thereby revealing the acquirer's intended strategy. A similar but more formal process is engaged if the acquiring firm wishes to issue a tender offer for a controlling interest in the firm. Form 14D must be filed, stating the offer price and other particulars of the tender.

Studies have shown that the stock price of the target firm can rise 25 to 30 percent after these announcements. However, a recent study at the University of Rochester also indicates that the stock price begins to rise even during the "silent" phase of an acquisition, suggesting that brokers and others in the marketplace use information on the volume of shares traded as an indication of nascent takeover activity. Also, the stock prices of other firms in the candidate firm's industry tend to rise sympathetically with increases in the target firm's stock price. In contrast, the stock price of the bidding or acquiring firm rises very little if at all during or after the merger or takeover process. This suggests that whatever gains were anticipated as a result of the combination are captured largely by shareholders of the target firm.

If the takeover is a hostile one, the management of the candidate firm may defend itself in several ways. In the case of a formal merger tender, it may

urge its shareholders to reject the offer and seek another (higher) bidder or accept the candidate firm's own counteroffer. In some cases, the candidate firm may borrow money to make a self-tender or make an exchange of shares for debt. The shareholders usually benefit in the case of a self-tender. The management also may react by buying back the shares bought by the acquiring firm at a premium in return for an agreement to stop the takeover attempt. Such transactions between management and the suitor are referred to colloquially as "greenmail."

Dann and DeAngelo find that the stock price of the candidate firm typically falls when greenmail is paid, reflecting the fact that the "greenmailer" has been partially successful in capturing the wealth of the corporation. In contrast, if the takeover fails because the parties are unable to come to terms or if the merger is disallowed by antitrust authorities, the share price remains above its preacquisition level. After more than two failed takeover attempts, however, the candidate firm's share price appears to revert to previous levels.

Why do firms merge?

Economists have used information on share price movements during the course of a takeover to understand the motives — and therefore the desirability from a social point of view — of takeover activity. One view of the dynamics is that stock prices respond because market participants interpret a takeover attempt as evidence of the existence of superior information about the prospects of the target firm or its industry. This hypothesis is consistent with the stock price increases observed during both the "silent" and formal takeover periods. Sympathetic price movements in the stocks of other firms in the same industry suggest that the market believed the new information was pertinent to the general prospects of the industry and not the management or structure of the candidate firm alone. According to this information hypothesis, the takeover need not actually occur to cause a permanent elevation in the share price of firms in the target industry. And, indeed, share price elevation usually does persist for a period of time even if a takeover attempt fails.

An alternative description of events underlying takeovers involves the notion of *synergy*. According to this hypothesis, firms seek to combine in order to exploit complementary productive or financial attributes. Their combined operations presumably would be more economical than that enjoyed by the entities separately. Such synergistic opportunities, of course, can only be enjoyed if the takeover actually occurs.

Bradley, Desai and Kim suggest that the behavior of target firm share prices is more consistent with the synergy hypothesis than the information hypothesis. In particular, they find that although the share prices of the candidate firm remain elevated when initial takeover bids are unsuccessful, the share prices of candidate firms remain elevated when initial takeover bids are unsuccessful, the share prices do drift back to pre-tender offer levels unless the takeover occurs. This does not explain, however, why the share prices of target firms rise even before the identity of the bidder is known (i.e., in the case of "silent acquisitions"), or when there is no outside bidder, as in the case of self-tenders. Moreover, it is possible that the lack of true permanence in the elevation of target firm share prices after a series of unsuccessful bids simply may reflect the market's re-evaluation of the quality of the original information.

A final, and less benign, interpretation of share price behavior is that takeovers represent events that increase monopoly power in an industry. Indeed, an increase in market power would be expected to result in an elevation of product prices, profits and, thereby, share prices. Some sympathetic increases in the share prices of competitor firms also might be expected since the prices received by all firms in the same industry might be elevated. Such an argument might have greater force if all mergers involved firms in the same industry, since that would enhance the concentration of market share (at least briefly, by perhaps facilitating anticompetitive, covert coordination of pricing behavior). However, the same pattern of share price elevation is observed in conglomerate takeovers when the bidder is from outside the industry.

In addition, the market power hypothesis fails to explain the appreciation in price experienced during self-tenders, which have no consequences for market structure. In leveraged buyouts, current shareholders receive premia (of as much as 50 percent) over prevailing market value to surrender control to current management. The fact that current shareholders are bought out at a premium

suggests that management's motivation has been increased by greater management participation in ownership and closer surveillance by other professional owners. (Tax advantages sometimes also flow from restructuring ownership.)

Management resistance

Management resistance also is a prominent feature of the natural history of most takeovers. Critics of management resistance argue that resistance is to be expected since the modern corporation is run not simply to maximize shareholder wealth (as assumed by economic theory) but also to indulge other preferences of the managers. As a result of such so-called "expense-preference" behavior, management (and perhaps employees of the firm generally) is reluctant to put its perquisites and power at risk even if the trade-off is some sacrifice of shareholder wealth.

Economist Harry Manne argues that competition between managements via takeovers has replaced shareholder vigilance in disciplining the management of firms. According to this argument, takeovers afford opportunities to replace complacent management and is one of the sources, therefore, of the observed appreciation in the value of the target firm's shares. Indeed, Jensen and Ruback report that share prices rise after a proxy fight even if the fight is unsuccessful; they suggest that just "putting management's feet to the fire" is productive.

Despite this view's appeal, it does have some logical shortcomings. As we have observed, prices of other firms in the target industry rise sympathetically after a tender offer. It seems unlikely that *every* firm's management suffers from complacency unless the structure or some other characteristics of the industry predispose it to expense-preference behavior. But if the industry were so predisposed, how could the market be certain that new management would behave differently?

Regardless of its motives, however, a recent study by Gregg Jarrell suggests that management's resistance to takeovers has the effect of stimulating other bidders and creating a competitive "auction" for the candidate firm. Thus, the wealth of a target firm's shareholders actually may be increased by resistance despite the costs of litigation, "greenmail" payments and other devices to thwart acquisition. Jarrell found that in fully 80 percent of the cases he studied, initial resistance resulted in more remunerative subsequent bids.

Too hard or too easy?

The fact that target firms' shareholders appear to capture most of the gains from takeovers and takeover attempts, despite or because of management resistance, may not be a cause for rejoicing. Since the bidders are, by definition, those who possess new information or notions about synergistic opportunities, their failure to capture the economic value of the gains may retard their attempts to do so.

Indeed, it could be argued that the requirement to register significant share acquisitions and tender offers with regulatory authorities may lead to inefficiency in the functioning of the stock market or the firms themselves. Moreover, if existing shareholders can be confident that they will capture most of the gains from new information about the assets or operations of firms through takeover attempts, they lose some of the incentive to scrutinize the behavior of current management. Viewed from this perspective, the problem with takeover activity may be that it is too *difficult* to accomplish for it to be a viable threat to complacent management.

In addition, the fact that most of the benefits of a takeover are captured by existing shareholders means that the holders of the debt and equity of the acquiring firm cannot expect to enjoy abnormally high (risk-adjusted) returns. Put differently, the high yields embodied in the loans and "junk" bonds used to finance takeovers are accompanied by high risk.

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 12/11/85	Change from 12/04/85	Change from 12/12/84 Dollar	Change from 12/12/84 Percent[7]
Loans, Leases and Investments[1] [2]	197,956	– 977	9,800	5.2
Loans and Leases[1] [6]	179,831	– 529	10,114	5.9
Commercial and Industrial	51,566	– 292	– 1,601	– 3.0
Real estate	65,908	149	4,291	6.9
Loans to Individuals	38,178	127	6,756	21.5
Leases	5,412	– 14	333	6.5
U.S. Treasury and Agency Securities[2]	10,725	– 506	– 810	– 7.0
Other Securities[2]	7,400	59	497	7.1
Total Deposits	202,983	– 792	10,569	5.4
Demand Deposits	50,748	– 692	5,790	12.8
Demand Deposits Adjusted[3]	34,324	557	5,436	18.8
Other Transaction Balances[4]	14,684	– 305	2,012	15.8
Total Non-Transaction Balances[6]	137,551	205	2,765	2.0
Money Market Deposit Accounts—Total	45,903	29	5,189	12.7
Time Deposits in Amounts of $100,000 or more	38,122	162	– 2,527	– 6.2
Other Liabilities for Borrowed Money[5]	23,620	– 4,178	1,957	09.0

Two Week Averages of Daily Figures	Period ended 12/02/85	Period ended 11/18/85
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (–)	68	40
Borrowings	148	19
Net free reserves (+)/Net borrowed(–)	– 79	21

[1] Includes loss reserves, unearned income, excludes interbank loans
[2] Excludes trading account securities
[3] Excludes U.S. government and depository institution deposits and cash items
[4] ATS, NOW, Super NOW and savings accounts with telephone transfers
[5] Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
[6] Includes items not shown separately
[7] Annualized percent change