# The new merger boom

**New combinations are reshaping America's largest industries, with consequences for all. Shareholders could be the big losers. ■ by Terence P. Paré**

LIKE A GALE, mergers are sweeping across America's corporate landscape, and the wind speed is picking up. As with the great merger booms of the Sixties and the mid-Eighties, this one, too, will leave its mark, affecting shareholder returns, business strategy, and employment trends; it may even affect the prices you pay for everyday products as competitors become fewer and more powerful.

It's been a long time since chief executives have been as eager to cut a deal as they are right now. Companies are looking for combinations in defense, telecommunications, transportation, health care, financial services, food, and entertainment. The activity has grabbed so many headlines that some key players have become celebrities. Marquee CEOs like Sumner Redstone, Martin Davis, Barry Diller, and Wayne Huizenga of Viacom, Paramount, QVC, and Blockbuster, respectively, provided classic M&A theater over the past year as they lunged and parried on the way to the creation of the new Viacom, the largest entertainment company in the U.S. Now the spotlight is on Quaker Oats' $1.7 billion bid for Snapple.

During the quarter ended September, the value of announced mergers and acquisitions climbed to a record $111 billion, easily outstripping the old mark set in the fourth quarter of 1988, according to Securities Data Corp. Though 1988 had more megadeals, which helped make the full-year deal tally of $336 billion a record that still stands, 1994's total just through October, $285 billion, isn't far behind. And measured by the number of transactions—5,800 so far this year, or about one per hour not counting Sundays—1994 is on a pace to become the deal-busiest year ever. Still, the appetite for action remains great. Says master matchmaker Eric Gleacher, who heads his own M&A boutique: "Top managements all have their lists of five companies that they are interested in."

One reason corporate execs can afford to think so expansively is that they are relatively cash rich. All that cost cutting of the past few years has produced an abundance of profits. Earnings for the Standard & Poor's industrials rose 13% last year on virtually flat sales, and Wall Street analysts expect double-digit earnings increases this year and next. Cash flow should be strong as well.

Some companies use spare cash to boost the payout to stockholders, while others resist

REPORTER ASSOCIATE *Patty de Llosa*

because such large payouts end up being taxed twice, once as corporate earnings and once as income to shareholders. What about more tax-efficient share buybacks, where companies boost their stock's value by buying up large blocks of outstanding shares? Says Daniel Tellep, soon to be CEO of newly combined Lockheed Martin: "You consider things like that, but they're not all that exciting." Urged on by wrenching change in government regulation, technology, and the competitive landscape, CEOs increasingly see the quantum leap of a big merger as their best use of corporate wealth—and their best chance for survival in a fast-changing marketplace.

Consider the transformation of America's defense industry. As weapons makers watched in dismay, Washington cut defense procurement spending by 67% from 1987 to the present. Says Norman Augustine, president-to-be of Lockheed Martin: "Our market isn't declining. It is truly collapsing." In response to that trend, 22 other defense industry mergers or major acquisitions have taken place since the end of 1992.

Where the government is not reshaping industries, the market is. In banking, the bread-and-butter business—commercial and industrial lending—is no longer growing as corporations increasingly turn to the financial markets for their capital needs. In the wake of that market shift, bankers have launched a phenomenal 1,422 mergers since 1989, according to Merrill Lynch's *Mergerstat Review*, as independents frantically strive to achieve economies of scale.

In technology and communications, every business born of microchips seems bent on merging. AT&T bought NCR, Hewlett-Packard snapped up Apollo, and now persistent rumors link IBM and Apple. The chip's almost magical power has reduced proprietary brand names and profitable market niches to a commodity-pit free-for-all where products become indistinguishable and profit margins get trampled. Mergers hold the promise of greater market heft and more pricing power.

**Viacom + Blockbuster + Paramount**

**In the most celebrated combination of the year, Viacom CEO Sumner Redstone (left) teamed up with Wayne Huizenga's Blockbuster to complete a successful takeover of Martin Davis's Paramount. Viacom stockholders have suffered.**

Taken together, the mergers of the past few years are more than a byproduct of economic change; they are themselves becoming a powerful agent of further transformations, changes that will redefine the nature of markets and competition.

Chief among those affected will be the shareholders of the acquiring companies, and there the news is not all good. Though the logic behind many of today's strategic deals is strong on its face, the odds against success are high. Combinations often fall prey to bad planning, unchecked egos, faulty pricing, or just plain bad luck. Many recent mergers have produced nothing but headaches and disappointment for the owners of the acquiring companies. Asked to name just one big merger that has lived up to expectations, Leon Cooperman, the former co-chairman of Goldman Sachs's investment policy committee, answers, "I'm sure that there are success stories out there, but at this moment I draw a blank."

Studies show that 33% to 50% of acquisitions are later divested, giving corporate marriages a divorce rate roughly comparable with that for men and women. One recent study reviewed over 30 years of research on the financial fallout from mergers. After assessing U.S. deals conducted from the turn of the century through the 1980s, Dennis Mueller of the University of Vienna summarily concluded: "On average, mergers are bad."

The problem most often is the price at which such seemingly sensible marriages tend to take place. As part of the merger drill, the buyer pays a premium over the market price to prompt the target's shareholders to sell. Theoretically, however, the pre-acquisition market value of a target company represents the present value of its future earnings potential, so the premium

# The big action in 1994

| Acquirer (or surviving entity) | Target (or merger partner) | Value of deal in billions |
|---|---|---|
| Martin Marietta | Lockheed | $10.0 |
| American Home Products | American Cyanamid | $9.7 |
| Viacom | Blockbuster Entertainment | $8.5 |
| Columbia Healthcare | Hospital Corp. of America (HCA) | $7.6 |
| Columbia/HCA Healthcare | HealthTrust | $5.4 |
| KeyCorp[1] | KeyCorp | $3.9 |
| Union Pacific | Santa Fe Pacific | $3.7 |
| Tele-Communications | Liberty Media | $3.4 |
| Burlington Northern | Santa Fe Pacific | $3.2 |
| American General | Unitrin | $2.6 |

[1]Name changed from Society Corp.

**Among the biggest deals this year, some, like American Cyanamid, are hostile, while others, like Lockheed Martin, are friendly mergers.**

paid, again in theory at least, yields no extra value. To earn back the premium, the acquirer must either sell off assets for more than it just paid for them or find a way to squeeze more earnings out of its new acquisition, feats that are not always as easily brought off as deal-hungry investment bankers would like their clients to believe.

CURRENTLY buyers are paying an average premium of 36%, according to Securities Data. For shareholders of the acquiring companies, that means that they are starting out 36% in the hole. That may look tame compared with the wild and woolly Eighties—bidders' premiums averaged 43% in 1988. But those "financial" buyers were playing a different game, exploiting untapped leverage in the target company. Though the strategy was cold-blooded and highly criticized, it tended to be highly profitable for the acquiring parties. One example: Clayton Dubilier & Rice, a well-known leveraged-buyout firm, achieved an 83% internal rate of return on its deals over the ten years ending in 1987.

Today's strategic buyers should be so lucky. But for some fairly obvious reasons, their story is far different. Strategic acquisitions are typically done with stock instead of debt, so whereas the Eighties buyer got leveraged profit potential, today's strategic buyer often gets its stock diluted instead. That doesn't go unnoticed by shareholders. G. William Schwert, a professor at the Simon School of Business at the University of Rochester, studied the stock market performance of over 600 mergers from 1975 through 1991. He tracked the performance of the surviving company in the three months following the announcement of its intent to merge. What he found confirmed the conclusions that dealmakers often admit only in private. Acquiring companies suffer. Adjusted for the movement of the market, the stock prices of the acquiring company fell on average about 4%. Says Schwert: "One explanation could be that the market doesn't see the same synergy that management thinks it sees."

With little faith in synergy, investors tend to focus on the price paid in deals, and they don't like what they see. Take Conseco's ongoing takeover of Kemper Corp., initiated last June. Conseco is the life insurance outfit based in Carmel, Indiana. Run by Stephen Hilbert, a former encyclopedia salesman, Conseco has been doing business only since 1982. But it has made a name for itself by acquiring insurance companies and slashing expenses to make them more profitable—and Hilbert fabulously wealthy; he was paid $14.5 million last year.

## The shakeup in defense

| Rank | 1991 ranking: Name | Military sales in billions | Current ranking: Name | Military sales in billions |
|---|---|---|---|---|
| 1 | McDonnell Douglas | $9.5 | Lockheed Martin | $11.6 |
| 2 | General Dynamics | $7.7 | McDonnell Douglas | $7.5 |
| 3 | General Electric | $7.2 | Northrop Grumman | $4.7 |
| 4 | Lockheed | $6.9 | GM Hughes Electronics | $4.1 |
| 5 | GM Hughes Electronics | $6.2 | Raytheon | $3.2 |
| 6 | Boeing | $5.6 | United Technologies | $3.1 |
| 7 | Northrop | $5.1 | General Dynamics | $2.2 |
| 8 | Raytheon | $5.0 | Loral | $1.7 |
| 9 | Martin Marietta | $4.5 | Boeing | $1.7 |
| 10 | United Technologies | $4.0 | General Electric | $1.6 |

**Lockheed + Martin Marietta**

**Mergers are changing the look of defense. Lockheed, maker of the Stealth fighter, is teaming up with Martin Marietta, maker of the Shuttle's fuel tanks, to be No. 1.**

Kemper Corp. is an old-line financial services outfit in Long Grove, Illinois. It has a reputation for being rather sleepy. For years employees at its headquarters could while away lunch hours angling for bass at a specially stocked lake.

Conseco made a pass at Kemper's annuity business as early as the spring of 1993, but found its attentions unwelcome. The following January, Gary Wendt, CEO of General Electric's big finance arm, GE Capital Corp., quietly visited Long Grove with an offer to buy all of Kemper for $45 a share, a premium of about 12% over the company's going price, provided that GECC could examine Kemper's real estate portfolio. Kemper sent Wendt packing.

A month later GE went public with a firm offer of $55 a share, and the bidding war began. Kemper set up a data room in Long Grove where suitors could examine confidential papers, and solicited offers from some 100 potential buyers. By the time Conseco beat out all the corporate blue-bloods in June, the price for Kemper had risen to $67 a share, or a 67% premium over the

company's market value at the beginning of the year. Kemper's stock was selling recently for less than $53 a share, while Conseco's stock has fallen from about $63 a share at the end of January to $37. As of early November, fearing a shareholder revolt, management was trying to backpedal on its bid.

**Chemical Bank + Manufacturers Hanover**
To lower costs, Walter Shipley's (left) Chemical and John McGuillicuddy's MHT joined forces in 1991. As banks merge, payrolls will decline.

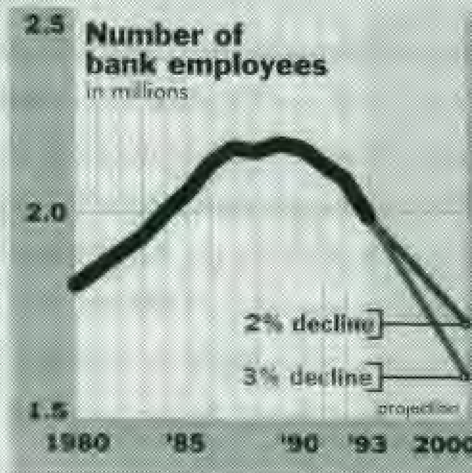
ONE AREA in which mergers do seem to make financial sense is banking—at least some of them do. With their once large corporate customers increasingly turning away from traditional loans in favor of alternative sources of financing, such as commercial paper, banks are being forced to rethink their business. Everywhere bankers look, competitors are encroaching: Salomon and Goldman Sachs now securitize commercial mortgages, and Microsoft's recent acquisition of Intuit, maker of electronic bill-paying software Quicken, has bankers worrying that software companies could eventually siphon off a piece of the banks' transaction-processing business.

Banks have to get their costs down if they wish to compete, and one quick way to accomplish that is to make an acquisition, which allows the bank to spread its fixed costs over a larger customer base. Says James McCormick of First Manhattan Consulting Group: "Consolidation will be a must for most large banks within the next few years."

But even here, where the logic is sound, the pricing of mergers, or the ambitions behind it, may not be. Banks are taking each other out through acquisitions priced at two times book value or more. In banking, book value is partly a reflection of a bank's branch network, and there is growing concern that banks are paying too much for branches that customers seem to need less and less.

What makes the most sense from an investor perspective are the combinations of overlapping entities, where branch networks can be consolidated and staffs reduced, quickly justifying the premiums paid. A new study by First Manhattan Consulting Group contends that mergers among banks with redundant branch networks offer potential cost savings of at least 35%, while a merger of two banks from disparate markets offers a potential cost saving of only 10% to 15%.

The biggest of the successful bank mergers is the 1991 joining of Manufacturers Hanover Trust and Chemical, two New York banks brought together through an exchange of stock. So far the merger-related reduction in head count at the surviving entity, Chemical Banking, has exceeded 6,000, and 80 branches have been closed. Reflecting that efficiency leap, the stock has outdistanced the S&P 500 as well as its banking industry peers (see table).




Such gains are not without a price. Layoffs will continue to be the fallout of further bank industry consolidation, says McCormick. His firm estimates that bank employment will decline 2% to 3% a year at least into the next century (see chart).

The economic sense behind mergers is more difficult to discern in media, where big distributors, like cable companies, hunger for Hollywood's content suppliers, and old-line telephone companies try to hedge their bets by buying cable companies. With all that dust getting kicked up, value is often lost in the shuffle. The great spectacle of the year, Viacom's acquisition of Paramount, not only tested the limits of prudent acquisition but expanded the limits of front-page ego wrestling, a show Viacom shareholders are now paying for.

First the courtly Sumner Redstone of Viacom announced that he was buying Paramount in September 1993 for some $8 billion in stock. A week later QVC's Barry Diller, who used to work for Paramount's tough-guy boss, Martin Davis, made a run at his former employer with a $9.5 billion offer. In December, Paramount terminated its deal with Viacom and made a date with Diller. Redstone began talking to Blockbuster CEO Wayne Huizenga about joining in the deal.

By January 7, 1994, Blockbuster had agreed to be acquired by Viacom for stock, allowing Redstone to figure Blockbuster's rich cash flow into his Paramount bid. With that new blood, Redstone went after Paramount again, upping his offer in Feb-

ruary. Diller countered, but his financing looked uncertain, so in March, Paramount shareholders went with Viacom, which finally purchased the property for a package of securities worth $10 billion, or $2 billion more than had been originally offered.

That dizzying shell game didn't fool shareholders. Viacom's stock had been heading south all through the negotiations, but it plummeted after the agreement to buy Blockbuster, falling from $42.75, at which it was trading when the deal was signed, to $21.75. Blockbuster plunged from $29.88 to $23.38 despite churning out a 46% jump in second-quarter earnings. The drop in stock values threatened Viacom's takeover of Blockbuster, but Viacom began selling assets, and its stock price recouped enough to seal the transaction, which was closed September 29, 1994, for some $8.5 billion.

Huizenga has said that he is happy with the outcome, but his employees, most of whom were Blockbuster stockholders, may disagree. After all, they were giving up a stock market rocket—Blockbuster's average annual total return over the past five years has been 27.7%—in exchange for more uncertain Viacom stock. Viacom shareholders may be grimacing too. Bear Stearns, which is bullish on Viacom, sees its price rising to only about $45 in the next six months, well below the $61 a share Viacom commanded before it went on the acquisition trail and about even with where it stood when it first signed the deal with Blockbuster.

For all the obstacles to success of any given

# Mergers past: the good, the bad, and the ugly

**These deals were the largest at the time, excluding leveraged buyouts. While stock price performance reflects many factors, on the whole these transactions suggest that mergers, strategic or otherwise, are nothing to cheer about.**

| Year | Acquirer<br>Industry group | Target | Value of deal<br>in billions | Stock price performance[1]<br>Acquirer's performance<br>pre-acquisition to present 9/30/94 | Industry performance<br>same time period | S&P 500 performance<br>same time period |
|---|---|---|---|---|---|---|
| 1989 | **Time Warner**[2]<br>Entertainment | **Warner Communications** | $14.0 | 32.1% | 132.9% | 64.9% |
| 1989 | **Bristol-Myers Squibb**[3]<br>Drugs | **Squibb** | $12.7 | 13.9% | 58.5% | 43.9% |
| 1989 | **Ford Motor**<br>Automobiles | **Associates First Capital** | $3.4 | 15.3% | 27.0% | 43.9% |
| 1989 | **Panhandle Eastern**<br>Natural gas | **Texas Eastern** | $3.2 | -6.1% | 28.3% | 75.4% |
| 1989 | **Black & Decker**<br>Hardware and tools | **Emhart** | $2.7 | -4.9% | 12.2% | 66.5% |
| 1990 | **Georgia-Pacific**<br>Forest products | **Great Northern Nekoosa** | $3.6 | 29.7% | 37.0% | 31.7% |
| 1990 | **ConAgra**<br>Food | **Beatrice** | $1.4 | 64.3% | 44.6% | 36.1% |
| 1990 | **MCI Communications**<br>Long-distance telecommunications | **Telecom-USA** | $1.2 | 60.2% | 35.7% | 38.7% |
| 1990 | **American International Group**<br>Multiline insurance | **International Lease Finance** | $1.2 | 82.4% | 44.3 | 39.4% |
| 1990 | **Dayton Hudson**<br>Department store | **Marshall Field** | $1.1 | 22.9% | 45.8% | 39.1% |
| 1991 | **AT&T**[4]<br>Long-distance telecommunications | **NCR** | $7.4 | 71.4% | 65.3% | 48.6% |
| 1991 | **GTE**<br>Telephones | **Contel** | $6.7 | -8.0% | 13.3% | 31.4% |
| 1991 | **NationsBank**[5]<br>Large regional banks | **C&S Sovran** | $4.7 | 31.1% | 55.4% | 23.0% |
| 1991 | **Chemical Banking**<br>Money-center banks | **Manufacturers Hanover Trust** | $1.8 | 89.2% | 79.6% | 25.5% |
| 1991 | **Harcourt General**[6]<br>Miscellaneous | **Harcourt Brace Jovanovich** | $1.5 | 100.4% | 59.2% | 46.8% |

[1]The starting point for the performance is two months prior to the announcement of the first bid. [2]Name changed from Time Inc. [3]Name changed from Bristol-Myers. [4]Name changed from American Telephone & Telegraph. [5]Name changed from NCNB. [6]Name changed from General Cinema.

deal, there are positive consequences to the merger boom. In the defense industry, for example, the consolidation under way has radically improved the prospects for the business, and it is already saving taxpayers a bundle. Defense companies operate mostly on a cost-plus pricing system—that is, they add up all their costs, tack on a profit, and present a bid for a project to Uncle Sam. If there are, say, six contractors bidding for a program and each is saddled with underutilized plants, all those price quotes will reflect the inescapably higher unit costs that result from idle factories. And the price of that underutilization is ultimately borne by the taxpayer.

When Lockheed and Martin Marietta announced their merger plans at the end of August, president-to-be Augustine said that Marietta's prior acquisitions of GE's aerospace division and General Dynamics' space division allowed him to remove about five million square feet of factories and offices that the separate companies would have been occupying. Those acquisitions, according to Augustine, will save U.S. taxpayers more than $1 billion over the next five years. Lockheed and Marietta together spend about $750 million a year on R&D, much of it duplicated. Combined, the companies can either cut costs or expand research into other areas.

But even in defense, not all the consequences are upbeat. Many highly trained and highly educated defense workers are finding themselves in the job hunt in middle age, in a marketplace that has radically changed. Many end up in very different professions. One of the favorite job choices for laid-off defense workers on Long Island is Home Depot. Here, engineers who once specialized in military-hardware design are now applying their skills—for far less pay—to guiding novice Mr. Fix-Its in the upkeep of their homes.

For now, the headline mergers in the defense business are done. The next round of action will be with the smaller contractors, which will need to merge to stay cost competitive in a shrinking business. Augustine contends that the industry as a whole is still two-thirds larger than it needs to be.

THE URGE to merge is just beginning for suppliers to the telecommunications business, in which the $11.5 billion AT&T/McCaw deal has been followed by a string of deals between wireless companies, wireless and cable companies, cable companies and telephone companies. The overwhelming force of convergence—the coming together of the technologies governing cable, conventional phone lines, and wireless—is transforming monopoly businesses into providers of a commodity service. Even the biggest players are feeling the need to have more full-service capabilities, and that means acquisitions.

Telecom equipment suppliers are scrambling to stay in sync with their customers' needs, and that means getting more full service themselves. According to *Mergerstat Review*, telephone equipment makers reported two mergers worth $236 million in the first nine months of 1994, compared with $143 million in all of last year. Other suppliers are forming alliances to develop the products the giants need. Raychem, out of Menlo Park, California, just announced a joint venture with Ericsson to develop the complex systems network operators like Bell Atlantic will need to realize such dreams as video-on-demand. Says Robert Kelsch, who will run the venture: "These networks are incredibly complicated. The same convergence that is forcing the operators together is forcing suppliers together because single equipment makers cannot satisfy the demands of the network."

The emphasis on greater efficiency and expanded capabilities is a driving force of the new merger boom. There are some unexpected beneficiaries of that push. Take health care. Under pressure from corporate customers to put a lid on employee health care costs, mergers are sweeping through every corner of this field, creating huge new combines. The idea is simple: Companies like Columbia/HCA buy up area hospitals and introduce economies of scale. HMOs follow much the same route, using acquisitions to build doctor networks that can attract big corporate accounts.

The one who makes out in all of this—aside from the corporate customer—is the family doctor who serves in the HMO as a gatekeeper. Says Thomas Hodapp, health care analyst at Robertson Stephens: "The primary-care doctor becomes a sort of general contractor." Under this arrangement, a primary-care doctor receives a monthly retainer based on the number of patients put under his care, plus a year-end bonus related to his ability to keep patients' medical expenses under control. As these entities merge, the costs go down, and doctors share in the savings.

Not surprisingly, a recent Ernst & Young survey of 53 health care organizations found that doctors in managed care make up to 38% more than their colleagues in fee-for-service operations. Supply is growing. Applications for medical school, about 46,000 this year, are higher than they have been for over 30 years. The jury is still out on what these changes will mean to the quality of care, but so far the evidence is encouraging.

Perhaps when the economy enters its next phase, the concentration of resources that now makes companies more efficient and competitive will become a problem. Nowadays, when price increases are almost taboo, such concerns seem far-fetched. But there is always the risk of inflation when prices are set by a few rather than many. That's a prospect that has Washington regulators increasingly ill at ease. In October the Federal Trade Commission blocked BAT Industries' attempt to buy American Tobacco because of worries that the deal would lead to higher cigarette prices. Within days of that, the commission forced drugmaker Eli Lilly to alter the terms of its acquisition of PCS Health Systems, a pharmacy benefits manager, because Uncle Sam feared that the deal was giving Lilly an uncompetitive pricing advantage. Says Kevin Arquit, former director of the Bureau of Competition: "The Clinton Administration has a very vigorous interest in anti-trust issues."

**"The Clinton Administration has a very vigorous interest in anti-trust issues."**

The merger boom of the Nineties is far from over, though it is already far enough along to make some early assessments. Like merger booms before, it will cause job dislocations. But it has, without question, added to the competitiveness of many American companies, and in some cases has rewarded shareholders handsomely, particularly the shareholders of the companies acquired. But it has also exposed the willingness of CEOs to use their company's stock as cheap currency in the pursuit of growth through acquisitions. Unless more shareholders rise up in protest, that trend could worsen. The legacy of the Eighties is that bondholders were too quiet for too long as acquisition-hungry CEOs destroyed credit ratings and bond values. To avoid a similar legacy, more stockholders need to make their voices heard, as Conseco's seem to be doing, and keep this merger boom from getting carried away. ■