Are Takeovers Hostile to Economic Performance?

John Pound, Kenneth Lehn, and Gregg Jarrell

THE RECENT INCREASE in hostile tender offers has spawned the development of many new defensive strategies designed to thwart the efforts of so-called corporate raiders. Target corporations become engaged to white knights or white squires, issue lollipops, and seduce their friends with crown jewel options. Failing this, they may pay greenmail, play Pac-Man, pop poison pills, or leave bidders with nothing but scorched earth to stand on. Although some takeover defenses ultimately fail, they all reflect a strategic intelligence that warrants considerable respect.

The architects of these strategies have not limited their creative efforts to economic markets. They and other critics of takeovers have been active in the political marketplace as well, advocating policies that would curtail, or even eliminate, hostile tender offers. Their first line of attack centered on the contention that hostile "raids" harmed shareholders of target companies. This argument has been soundly rejected by a large body of empirical evidence, and most takeover critics now concede that takeover activity enriches shareholders of target companies quite substantially.

Given the constraints posed by the evidence, critics' charges have evolved into a sweeping criticism of institutional investors and the efficiency of the stock market. If correct, their contentions have extraordinary policy implications that go beyond the issue of hostile tender offers. Variants of these arguments can be found in all public forums in which the takeover issue is debated, from congressional testimony to the pages of academic journals.

The critics have relied largely on *ad hoc* propositions and personal business judgments to support the new arguments against corporate takeovers; to date, they have offered no concrete or systematic evidence. The new arguments can, however, be tested directly, and over the past year we have gathered and analyzed the data to do so. On the basis of this new evidence, the critics' recent charges should be rejected just as strongly as their earlier charges of shareholder impoverishment.

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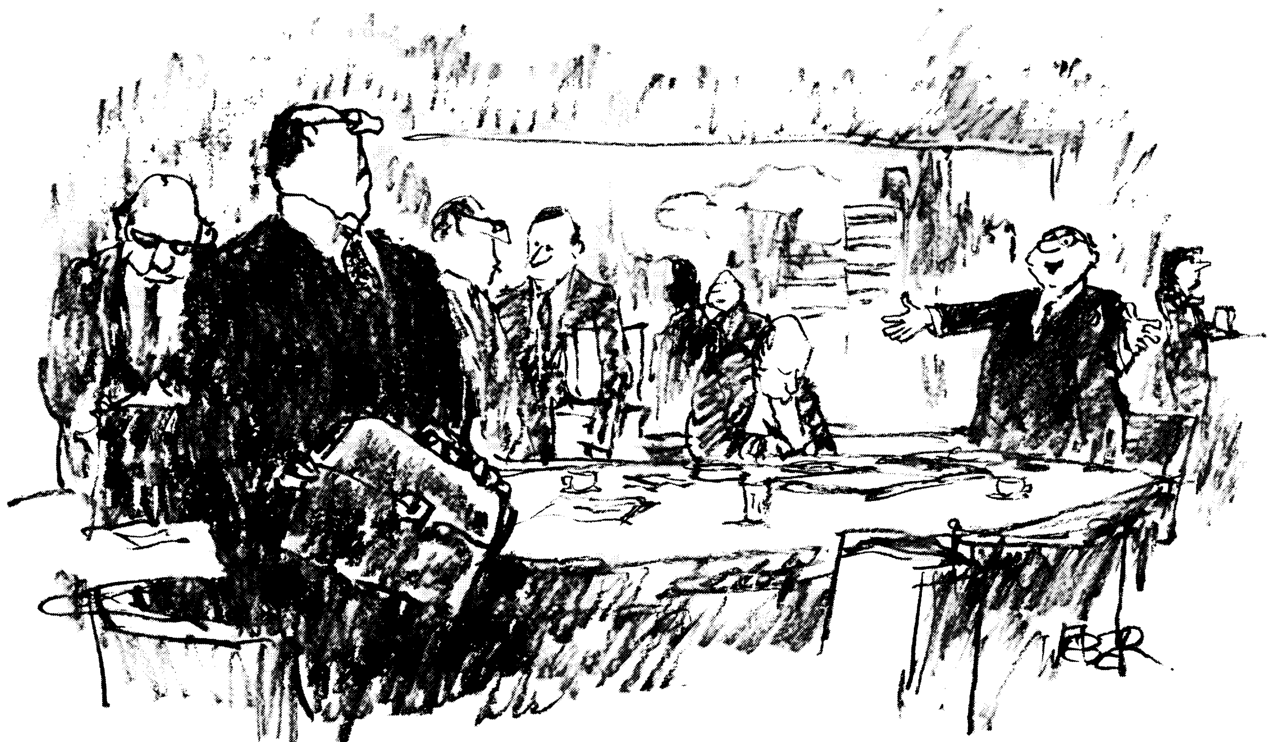
The New Case Against Hostile Takeovers

The new case against hostile takeovers stems from a fundamental suspicion about the ability of capital markets to value corporate assets prop-



"Now that the merger is completed, Stahlmeyer, how's about a hug?"

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erly. Critics contend that many takeovers—and most hostile raids—are caused by chronic undervaluation of the securities of target corporations in the stock market. According to this view, bidding firms search for and discover underpriced corporations, then acquire them at terms that are attractive to the bidder and the target shareholders but harmful to the corporations' long-term economic health.

This logic runs counter to the conventional economic view of takeovers, which holds that bidders can pay substantial premiums because of the increase in profitability they expect to bring to the management of the target firm's assets. If, as suggested by the critics' view, the bidder's role is no more substantial than that of a savvy used-car shopper, able to spot the underpriced gems on the lot, then it is hardly likely that takeovers increase efficiency. Further, if hostile takeovers lead to unproductive management in the long run, a target management that tries aggressively to protect its assets from the bidder actually is doing society a service.

Despite 20 years of academic research that generally confirms the efficiency of equity pricing, the argument that we should not trust the stock market to evaluate the economic worth of corporations has become a strong rallying point for takeover opponents. The view plays to the common perception that the stock market is little more than a casino. Recent congressional testimony by Andrew Sigler, chairman of Champion International and a major spokesman for the Business Roundtable, reflects the importance attached to inefficient stock prices in the arguments made by takeover critics:

> Proponents of hostile takeovers conclude that because of the willingness of acquirers to pay more than the market price for the stock, the assets of the enterprise are put to a more efficient use and thereby the economy is benefitted. This is nonsense . . . .The stock market which is the starting point of these economic analyses is a notoriously inexact measurer of the value of companies.

What causes irrational undervaluation? The primary cause, critics contend, is that the stock market is excessively concerned with short-term earnings, an accounting fiction often bearing little relationship to a firm's long-term prospects. By critics' logic, the stock market is myopic in the way it values shares of corporations, undervaluing those corporations with favorable long-

term prospects; firms that ignore this tendency and pursue sound long-term policy will sustain a diminished stock value that is likely to invite a hostile tender offer. Managers are thus caught between Scylla and Charibdis, unable to concentrate on long-term planning without inviting unwanted attention from raiders.

Critics argue that much of the myopic focus on short-term performance can be traced to the increasing dominance of institutional investors (such as pension and mutual funds) in equity ownership in the United States. In contrast to the traditional individual shareholder, institutional investors assertedly have short time horizons. This is said to derive from two sources: the fiduciary responsibility of fund managers, and the intensely competitive market for money managers that results in quarter-to-quarter monitoring of their performance. Besides exacerbating the market's tendency to undervalue corporations that plan for the long-term, critics contend this short-term performance pressure makes institutions over-eager to tender shares to any bidder offering even a small premium over market price. Marvin Lipton, a prominent corporate lawyer who has been an active participant in the takeover debate, summarized this contention in an editorial in the *Wall Street Journal:*

> Institutional investors . . . exacerbate the situation by preferring short-term gains to long-term growth. Indeed, because most of the large publicly held corporations are effectively controlled by institutional investors, the coordinated activity of takeover entrepreneurs and institutional investors threatens every large public company that sells in the stock market for less than its liquidation value.

Another charge levelled by takeover critics is that the stock market is too-little concerned with "clean" balance sheets—that is, with low, manageable levels of debt. Low debt-equity ratios, they argue, reflect good corporate health. Because the stock market undervalues low debt, raiders are said to be able to take over firms with especially clean balance sheets, financing their acquisitions by leveraging the firms with massive amounts of new debt.

In short, takeover critics argue that hostile tender offers are driven by an irrational stock market which is aided and abetted by the short-term opportunism of some market participants. A set of far-reaching dangers and consequences for the American economy are seen to flow from this economic environment. Harold Williams, former chairman of the Securities and Exchange Commission, writing in *Fortune,* put it this way:

> [T]he threat of takeover imposes a cost on management and on the economy that cannot be quantified but is real nonetheless. A management spending its days and nights with lawyers, public relations firms, and investment bankers is not spending enough time developing new products, manufacturing more efficiently, or improving its balance sheet. In fact, a company would be foolhardy to improve its balance sheet and make itself a more tempting target for raiders. The loss in management effectiveness works against corporate and national productivity, the wages of employees, and returns to stockholders. It undermines our economy and our society . . . .The competitiveness of the U.S. corporations has already been impaired by the failure to make long-term commitments. To compound the problem because of fears of takeovers is a gift to foreign competitors that we can not afford.

The Critics' Legislative Agenda

If, as critics suggest, the market cannot price firms correctly—indeed prices them perversely—then there is little to be gained from takeover activity. Not surprisingly, critics are vigorous supporters of placing sharp new restrictions on takeover activity.

Recent proposals generally fall into one of three categories: those that would result in an across-the-board ban or moratorium on hostile control contests; those that would effectively mandate that a federal regulatory agency determine, on a case-by-case basis, the merit of proposed takeovers; and those that would "reform" and "rationalize" the takeover process in various ways, such as by guaranteeing target shareholders the right to vote on takeover offers. Even this latter group of proposals, which appears harmless enough to some, would severely restrict takeover activity. By introducing delay into the process, they might well eliminate any remaining gains accruing to bidding firms from making acquisitions.

In the past two years, takeover opponents have found ready allies in Congress and state legislatures. During 1985 alone, more than 50 bills were introduced into Congress designed to re-

strict takeover activity, although none passed. At the state level, critics have had considerably more success, with many new statutes enacted in the past few years that restrict takeover activity. While it is entirely possible that these laws will be invalidated by the Federal courts, much as happened with the spate of takeover restrictions enacted by states in the 1970s, they will continue to pose severe restrictions in the meantime.

For those who believe the takeover market is basically efficient, these new restrictions are seen as deterrents to economic efficiency. It is not just the "discipline" on lax management that is lost if takeover activity is curtailed; indeed, this may be the least important cost of restrictive new regulation. The real cost stems from placing additional constraints on the most efficient medium we know for effecting economic change—direct transactions in the capital market.

Those who oppose efforts to further restrict takeover activity argue that takeovers are motivated by many underlying causes, none of which are related to stock market inefficiencies. These include competitive readjustment to changing market conditions, deregulation, and the potential for increased profits from the combining of firm-specific assets. A casual examination of takeover activity since 1980 suggests strongly that the preponderance of recent activity has come in response to changes in world market conditions, particularly in the oil industry, and rapid deregulation in many important markets, including the airlines, communications, and broadcasting. In changing market conditions, old ways of doing business may no longer apply. Takeovers then represent an adaptive response allowing swifter adjustment to changing market conditions.

It is not necessary to hold the view that every takeover is efficient to believe that the economy generally benefits from takeover activity. Regardless of the merits of any particular case, new restrictions on the takeover process deter industrial evolution and market adaptation.

Testing Critics' New Allegations

Like the early charges made by takeover critics, the new litany of charges is directly testable. To test the charges, we isolated the specific hypotheses about market undervaluation, corporate performance, and institutional ownership contained in critics' charges. We then subjected each to a formal test, using both accounting and financial data on major corporations. Our analysis is generally concentrated on the post-1980 economic environment.

The new evidence, presented below, serves as further confirmation of the large existing literature suggesting that the market for corporate control is efficient. Of the numerous tests we performed, not one supports the critics' charges. In fact, many of the tests yield results that directly contradict these charges.

• **Takeover Targets Do Not Focus More Heavily on the Long-Term.** The charge that hostile tender offers exploit corporations which focus on long-term planning is perhaps the single most damaging of the critics' charges. To examine whether firms become targets because of a greater focus on long-term planning, we looked for evidence on whether firms that are takeover targets are characterized by a higher level of expenditures on long-term projects than other companies.

One direct measure of commitment to long-term projects can be found in expenditures on research and development. These expenditures clearly reduce short-term earnings in favor of long-term economic payoffs. We collected data on the relative level of R&D expenditures—actually the ratio of R&D outlays to revenues—for all 217 takeover targets that were acquired between 1980 and 1984 and compared it with data for non-target firms in the same industries. Of the 217 target firms, 160 firms reported that their R&D expenditures were "not material." With such a high percentage of targets—74 percent—reporting no material R&D outlays, it would be incorrect to identify targets as being firms with intensive R&D activity. For the remaining 57 target firms, the R&D ratio was found to be less than one-half the ratio for the industry control group—0.77 percent as compared to 1.66 percent in the year immediately preceding the tender offer. (The results are virtually unchanged when the measuring period is lengthened to three years preceding the offer.) Investment in long-term projects such as R&D is clearly not what makes corporations vulnerable to takeovers.

A second measure of long-term commitment is the relative level of capital expenditures. We examined capital expenditures for three randomly selected groups of takeover targets in the period 1979-84 and a control group of 46 nontarget firms. The three subsets are: targets of

Table 1
CAPITAL EXPENDITURES AND CASH FLOW IN TARGET FIRMS

	Control Firms	Takeover Targets		
		Friendly: Target Acquired	Hostile: Target Acquired	Hostile: Remained Separate
Capital/ Earnings	2.44	1.75	1.79	1.75
Cash Flow/ Earnings	2.42	2.07	2.11	1.79

Average ratio of capital expenditures to earnings and average ratio of cash flow to earnings in two-year period before takeover attempt.

friendly bids that were ultimately acquired (40 firms), hostile targets that were ultimately acquired (41 firms), and hostile targets that successfully fought off takeover bids to remain independent (32 firms).

The results of this inquiry are included in Table 1. Averaging over the two years prior to the takeover attempt, the data reveal no difference between the relative level of capital expenditures to earnings across the three subsamples of takeover targets. By contrast, this ratio is slightly higher for the control sample of nontarget firms. As with R&D, these results suggest that the theory that long-term commitments are higher in target firms should be rejected.

• **Takeover Targets Do Not Have Higher Cash Flows.** Another way to test the view that hostile takeovers are motivated by short-run opportunism is to see whether takeover targets have high cash flows camouflaged by low earnings. Cash flow is a simple measure of resources currently accruing to the corporation. The critics' charges imply that the ratio of cash flow to earnings should be higher for targets of hostile tender offers than for other firms.

Table 1 displays the ratio of average cash flow to earnings for the three subsamples of takeover targets and the control sample described above. Consistent with the results on R&D and capital expenditures, takeover targets appear to have lower, not higher, cash flows than do firms in the control sample. Furthermore, this ratio does not differ significantly between hostile and friendly merger targets.

• **Takeover Targets Do Not Have Low Debt.** Table 2 displays three measures of debt—or leverage—for the three subsets of takeover targets described above, and for a control sample of firms from the market. These data tell a surprising story. No significant differences exist in the ratio of current assets to liabilities for any subset of takeover targets. However, long-term debt, measured against either capital or equity value, is higher for hostile targets that defeat takeovers than it is for other targets or for the market.

These data are surprising because among all perceptions about takeover targets, perhaps the most popular is that they have clean balance sheets. The data show this perception to be inaccurate. This finding only reinforces our belief that it is easy, in a vivid arena such as the takeover market, for perceptions to take hold that have no basis in fact.

• **Institutional Investors Do Not Foster Takeover Activity.** The charge made by takeover opponents that institutional investors are over-eager to tender shares implies that firms

Table 2
RELATIVE DEBT POSITION OF TAKEOVER TARGETS
(YEAR BEFORE TENDER OFFER)

	Control Firms	Takeover Targets		
		Friendly: Target Acquired	Hostile: Target Acquired	Hostile: Remained Separate
Current Assets/ Liabilities	2.280	2.420	2.390	2.460
Long-Term Debt/ Outstanding Equity	0.444	0.430	0.433	0.575
Long-Term Debt/ Total Capital	0.244	0.230	0.252	0.316

with high institutional ownership should be easier to acquire, and thus that institutional ownership should be more prevalent in target firms than in nontarget firms. To test this, we gathered data for all target firms filing institutional ownership reports with the SEC during the period 1980-1984. The average percentage of equity held by institutional investors in these firms just prior to the takeover bids was approximately 20 percent. The corresponding percentage for firms in the same industries, and the market overall, was about 33 percent. Although some of this difference may be attributed to differences in firm size, the data suggest that high institutional ownership itself is not what fuels takeover bids.

The critics' contention that institutions will tender at negligible premiums also implies that we should observe lower takeover premiums paid for targets with higher institutional ownership. Tables 3 and 4 demonstrate that this is not the case. The tables compare average premiums in those post-1979 takeover attempts where institutional ownership was highest, moderate, and lowest, and compares institutional ownership in target firms generating the highest and lowest takeover premiums. The data show quite clearly that institutional ownership has no discernible effect on takeover premiums.

Finally, the critics' view implies that targets with high institutional ownership should have proportionately greater difficulty defeating takeover attempts because institutional shareholders are more likely to tender against the wishes of target managements. If this is the case, then companies which successfully defeat takeover attempts should have lower institutional ownership than the average takeover target. Yet, once again, the data reveal no differences in institutional ownership between the samples of defeated targets and other targets—the average institutional ownership in both cases is between 22 percent and 23 percent.

Table 3
INSTITUTIONAL OWNERSHIP AND TAKEOVER PREMIUM

Institutional Ownership	Takeover Premium
Average of 2% (negligible)	43.2%
Average of 53.8% (controlling)	43.8
Average of 40%-50%	45.9
Full Sample of 100 Firms	45.4

Together, these tests refute the charge that institutional investors foster hostile takeovers. High institutional ownership does not appear to stimulate takeover attempts nor does it appear to make target firms cheaper to acquire or to place target managements that are opposed to takeovers at a handicap.

Table 4
INSTITUTIONAL OWNERSHIP OF FIRMS BY SIZE OF TAKEOVER PREMIUM

Takeover Premium Decile (and Avg. Premium)	% Institutional Ownership
Top Decile (100.3%)	24.9%
Bottom Decile (5.9%)	23.4
Full Sample of 100 Firms	22.2

• **Institutional Investors Do Not Shy Away From Heavy R&D.** Critics contend that high or growing institutional ownership forces corporate managers away from long term activities in order to boost short-term earnings and avoid takeovers. This charge implies that looking across the entire market—rather than only at takeover targets—we should observe relatively low investment in long-term projects by companies having high institutional ownership, and vice-versa.

To test this contention, we examined a large set of firms that had significant R&D expenditures in the 1980s. Our examination focused on the 324 firms covered by *Business Week's* "1984 Annual R&D Scoreboard," a statistical summary of R&D expenditures by firms in research-intensive industries. For each of these firms we collected annual data on percentage of equity held by institutional investors, and on the ratio of R&D expenditures to revenues.

As shown in Table 5, institutional ownership in these firms increased steadily from 30 percent of common equity in 1980 to 38 percent in 1983. Yet, during the same period, there was also an increase of approximately 19.2 percent in the average ratio of R&D expenditures to revenues. Thus, in a period of increasing institutional ownership, there is no evidence that corporate managers have become disinclined to invest in short-term projects.

Since the level of a firm's R&D expenditures is determined by many factors, we also analyzed more closely the incremental relation between

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