Advance Text

New York Financial Writers
Sheraton Center
New York City
June 7, 1984

The Leveraging of America

John S.R. Shad

Ladies and Gentlemen:

This evening, I would like to discuss newsworthy trends and developments in corporate takeovers and buyouts that I believe will significantly impact American enterprise next year and beyond.

The first concerns the increasing tendency of institutional investors to oppose anti-takeover proposals by corporate managements.

The second concerns the consequences of leveraged takeovers and buyouts of major corporations.

My purpose is not to sound a note of alarm, but to ventilate some of the major issues that should be weighed by the financial press, the business and financial community, the Congress and the SEC, in conjunction with ongoing discussions of the laws and regulations which govern changes in corporate control.

More Institutional Dissents

Until last year, institutional investors' opposition to management proposals has been negligible. However, last year they and other investors defeated anti-takeover proposals by a number of companies, including Castle and Cook, Data General, International Paper and Sherwin-Williams, to name a few.

Despite management opposition, Superior Oil's shareholders created a committee of independent directors to evaluate future tender offers, and rescinded a protective stock dividend plan.

Shareholders have been very critical of companies that have repurchased blocks of their stocks at premium prices from possible bidders.

In a 1983 Kidder Peabody & Co. and Morrow & Co. survey of 2,500 institutions, 75% opposed requirements that mergers be approved by super majorities of the shareholders, and half opposed staggered boards (i.e., the election of less than all the directors annually).

In an Investor Responsibility Research Center survey last year, a "wide margin" of institutions opposed both such provisions and favored requiring shareholder ratification of "golden parachutes."

In a D.F. King study, 75 of 100 major institutions were generally opposed to increasing management protective provisions.

Citicorp's $36 billion Investment Management division is reported to have voted against all anti-takeover proposals by 64 companies in which it holds stock.

The $11 billion Batterymarch Financial Management has adopted a policy of voting against anti-takeover proposals and of announcing publicly its votes on specific issues.

With only a 1% interest in the TWA holding company, Odyssey Partners obtained a 30% vote in favor of breaking-up the company, based on the proposition that the parts were worth more than the whole.

A projection of these trends suggests that a rising number of institutions will not only oppose future anti-takeover proposals by managements, but also begin to support corporate break-ups and mergers, with a view to enhancing the value of their investments.

The Rising Tide of Leveraged Takeovers and Buyouts

These trends lead into the second topic - the consequences of the rising tide of leveraged takeovers and buyouts of major American corporations.

Shareholders typically receive 50% to 100% premiums over the current market prices of their shares. However, the longer term consequences to shareholders and the nation should not be ignored.

Corporate takeovers and buyouts are financed through large loans. The net effect is that debt is being used to retire equity, which is known as leveraging-up a company's capitalization. The greater the leverage, the greater the risks to the company, its shareholders and creditors.

Common Characteristics of Targets

Companies that are being takenover or boughtout generally have one or more of the following characteristics: significant untapped borrowing capacity; shares trading at discounts from the current market value of their net assets; and at low multiples of their cash flows (i.e., their net incomes plus depreciation, depletion and other non-cash charges).

The foregoing - untapped borrowing capacity, undervalued assets and low cash flow multiples - are also common characteristics of many, if not most, of America's largest and soundest corporations.

Under such circumstances, buyers are able to finance-out a major portion of the purchase price against such companies' own assets and cash flows. When they do so, it is usually necessary to dedicate such cash flows to future debts service, rather than the replacement of aging plant and equipment and declining oil or other reserves. Companies that do not replace aging facilities and declining reserves, become increasingly inefficient.

Also, under current economic conditions, conservatively capitalized companies - those with low debt-equity ratios - have great incentive to borrow funds and reacquire their own shares or those of other companies, rather than suffer the consequences of such tactics by others.

In today's corporate world, Darwin's "survival of the fittest", has become - acquire or be acquired.

Management Leveraged Buyouts

Leveraged buyouts by managements have been a fraction of leveraged takeovers of one company by another. In my opinion, shareholders would generally prefer to have managements place their companies on the block at premium prices, rather than use their companies' resources to fight off bidders. Management buyouts have often attracted higher bids from others. Examples include City Investing, Northwest Energy, Norton Simon and Stokely-Van Camp.

Optimum Economic Environment

The past 24 months have been an optimum economic environment in which to effect leveraged takeovers and buyouts.

Corporations' tax deductible depreciation and depletion allowances are based on historical costs. Such allowances have long been inadequate to replace plant, equipment and reserves at current inflated prices. The Economic Recovery Tax Act of 1981 increased such allowances, which has in turn increased corporations' cash flows and liquidity. In addition, the past 24 months have witnessed relatively low interest and inflation rates, and a vigorous economic recovery. This combination of events has facilitated the rising tide of leveraged takeovers and buyouts.

More Bankruptcies in Prospect

However, major bankruptcies have resulted from the heavy debt incurred by companies engaged in aggressive acquisition programs. To name a few: Baldwin-United, Charter Corp., Lionel, Saxon Industries, Wickes and many others.

When a company has highly leveraged its capitalization, the consequences of even modest business problems, economic recessions or rising interest rates, are greatly magnified. Shareholders, creditors and others have sustained billion dollar losses as a consequence of the leveraging-up of American enterprises.

The more leveraged takeovers and buyouts today, the more bankruptcies tomorrow. During the past few years, the multi-billion dollar premiums shareholders have received in leveraged takeovers and buyouts have been a multiple of their losses from acquisition related bankruptcies. However, the leveraging-up of American enterprise will magnify the adverse consequences of the next recession or significant rise in interest rates.

Marketplace Disciplines

The theory that contested takeovers discipline incompetent managements is of limited veracity. Corporations have momentum. Today's corporate performance and stock prices are in large measure a function of yesterday's decisions, by prior managements - whether good or bad.

Companies that borrowed at the low interest rates 12 years ago to buy oil reserves at the low prices then, and subsequently retired such debt with inflated dollars, are reaping the rewards today of prior management decisions.

In addition, outstanding executives are often engaged to turn around ailing enterprises. The market prices of such companies' shares often lag their improving prospects, and they become attractive takeover candidates, because of the competence - not the incompetence - of their managements.

Also, contrary to a discipline, the increasing threat of being takenover is an inducement to curtail or defer research and development, plant rehabilitation and expansion, oil exploration and development, and other programs - which entail current costs for long-term benefits.

More Exchange Offers in Prospect

Now, I would like to turn to exchange offers, that is offers to exchange one company's securities for those of another. Contested takeovers through exchange offers have been negligible. However, if proposed regulatory changes are adopted, I believe next year will witness a significant increase in both friendly and contested takeovers through exchange offers - and through combinations of open market accumulation, securities exchange offers, cash tender offers and statutory mergers.

Last year, the SEC Advisory Committee on Tender Offers recommended that exchange offer regulations be simplified and accelerated. The Commission is currently soliciting public comments (by August 17th), on proposals that would significantly reduce the paperwork for business combinations and exchange offers. The SEC will also release for public comment shortly, proposals that would permit exchange offers to be done as rapidly as cash tender offers.

Advantages of Exchange Offers

There are many advantages to exchange offers:

- They eliminate the necessity for corporations to borrow the large sums required to effect cash tender offers.

- Multiple transactions can be telescoped into a single transaction. There is no need to refinance the short-term debt incurred to affect cash tender offers.

- Cash tender offers are taxable transactions. Exchange offers of voting equity securities are not - and such acquisitions can be accounted for as poolings of interest, rather than as purchases. In poolings, the premiums over book value paid for target companies do not have to be amortized.

- And finally, the fairness of partial and two-tier tender offers have been questioned. Exchange offers facilitate offers for all of a company's shares, rather than for only a portion of them.

Exchange Offer Consequences

Therefore, why shouldn't exchange offers be streamlined and accelerated? They probably should, but not without assessing the consequences.

One consequence is that small companies can do exchange offers for the shares of large corporations on a basis under which they are simply recapitalizing the larger corporations. The larger corporations' assets and earning power become the credit behind the new securities.

Such exchange offers might consist of packages of common and preferred shares, warrants, zero coupon bonds or other exotic financial instruments, designed to accommodate such offers. They will be successful, if arbitrageurs, institutional investors and others conclude - or if the when-issued market value of the package of securities clearly demonstrates - that the securities offered are worth significantly more than the market prices of targets' common stocks, before the offers.

Through combinations of exchange and tender offers, targets' capitalizations might thus be leveraged-up, and their managements succeeded by those of smaller companies, that may have limited knowledge of targets' operations.

In order to do cash tender offers, bidders typically have to seek lines of credit from banks and other institutions. Thus, cash tender offers generally require the support and concurrence of institutional lenders. Such support or concurrence is not generally required to do exchange offers. Bidders simply create their own "corporate currencies" (i.e., packages of securities) and offer them in exchange for targets' securities.

The longer time periods and more detailed registration requirements for exchange offers have permitted target companies to block or delay them through legal actions, often based on deficiencies in the registration documents or other contentions. Targets have also used the longer time to seek higher bids from others. For these reasons, there have been relatively few contested exchange offers. However, there will be more if they are accelerated, and the consequences may include greater leverage in corporate capitalizations and less experienced managements.

In the open meetings that preceded the Advisory Committee's recommendation to accelerate exchange offers, these implications were not discussed. These and related issues should be factually addressed by those who respond to the Commission's releases on streamlining and accelerating exchange offers.

One of many possibilities would be to limit accelerated exchange offers to the largest and most creditworthy companies - as in the case of accelerated public offerings of securities under the shelf registration rule. Companies that are not widely followed by the investing public and that do not enjoy broad active public markets, might be limited to conventional exchange offers.

It should be noted in this regard that the SEC is charged with the implementation of the laws passed by Congress, principally through the medium of full disclosure. The SEC does not have or desire the authority to pass on the merits of corporate financings, mergers or acquisitions. Congress has wisely concluded that such judgments are better left to the marketplace.

Conclusion

In conclusion, as mentioned at the outset, these are some of the issues that should be weighed in conjunction with ongoing discussions of the laws and regulations which govern changes in corporate control.

It would be as wrong to overreact to these issues, as it would be to ignore them.

Notwithstanding concerns to the contrary, multi-billion dollar leveraged takeovers and buyouts have not had a disruptive effect on the credit markets. As bank loans have been drawn down by bidders and paid to target companies' shareholders, the funds have been instantly recycled - redeposited or reinvested by the shareholders. And bidders' short term bank loans have generally been reduced within a year or two through long term debt and other financings or through asset liquidations.

There are major operational, financial and other advantages of corporate consolidations, that should not be foreclosed in an attempt to address ancillary issues. The evolutionary response of the marketplace to changing business conditions has been much more effective than less flexible laws and regulations.

Thank you.