Is Takeover Fever Jeopardizing Our Nation's Health?

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IS TAKEOVER FEVER JEOPARDIZING OUR NATION'S HEALTH?
by Ellen Magenheim

Although the visionaries of corporate America intermittently predict that merger mania will soon subside, every day brings an announcement of another takeover bid. Indeed, in the first half of 1987 alone, over 2,000 takeovers were announced. The frenzy continues despite tax law changes, tighter state antitakeover laws, and insider trading scandals linked to mergers and acquisitions. The question is, can our economy continue to support this buying spree?

Supporters of takeover activity argue that acquisitions, especially when hostile, are the most effective device for disciplining entrenched management and restoring the competitive spirit in corporations. This argument suggests that target firms are inferior performers. But research indicates the contrary. A study of 15 hostile takeover targets in 1982 and 1983 found that the rate of return for the targets averaged 18 percent, well above the average rate of return for all companies during that period.

There is growing evidence that premiums for shareholders in acquiring firms are mounting. Research shows shareholders in acquiring firms can expect a rate of return of 5 to 16 percent for the first three years following a takeover. Clearly, shareholders of acquiring firms, takeover announcements are not always cause for celebration.

Increasing leverage and increasing institutional ownership may be compensated with higher lead managers to make distorted decisions based on concerns for short-run performance.

There is growing evidence that premiums for shareholders in target firms grow larger, losses to shareholders in acquiring firms are mounting.

Increasing leverage and increasing institutional ownership may be compensated with higher lead managers to make distorted decisions based on concerns for short-run performance.

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are not earning enough to meet interest payments, their options—reduce real investment, raise funds by selling off profitable divisions, issue more debt to finance the existing debt, or declare bankruptcy—are not attractive ones.

Increasing leverage along with increasing institutional ownership may also lead managers to make distorted decisions based on excessive concerns for short-run performance. For example, managers of potential target companies, fearful that growing numbers of institutional shareholders might tender shares quickly, would be tempted to use strategies aimed at keeping share prices up at the expense of their organizations' long-run financial health.

The effects of this overemphasis on the present at the expense of the future are not confined to stockholders. Consider corporate investments in research and development. Undertaking a risky, long-term project is something that managers lose sleep over in the best of times. Imagine that it is not the best of times: the debt burden is heavy and the institutional shareholders are breathing down your neck. If your company's share price declines, even temporarily, you know that stockholders are ready to tender to the first bidder who offers a premium. Would you make investments in R&D then?

In the end, to suggest that the result of takeovers is a net gain for most shareholders, and therefore the economy, is simplistic. It overlooks the fact that some shareholders gain at the expense of others. It also overlooks the risks of increasing bankruptcy and unemployment rates when too many companies are highly leveraged. Without better understanding of these and other troublesome effects, the negative impact of takeover fever on our nation's economic health is simply too much to ignore.

Ellen Magenheim is assistant professor of economics at Swarthmore College.

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