

Merger Waves in the 19th, 20th and 21st Centuries

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Mergers and merger waves and the factors that give rise to them have been the subject of intense interest for more than a century.

When the concept of merger waves and the issues of the effect of mergers on company profits and the economy as a whole started to interest me in the early 1960s, I had already embarked on my career as an M&A lawyer.

As the years went by, I became fascinated by the economic and social issues posed by mergers, as well as the legal, financial and market issues created by mergers and hostile takeovers.

As many of you may know, although over the past 50 years I have advised on many of the major mergers and takeovers of the period, I have been and continue to be skeptical about the love affair by academics of the Chicago School with the so-called “market for corporate control.” In particular, I do not accept the efficient capital market and agency theories advanced by academics to justify hostile takeover bids. My views are set out in a series of articles beginning with the 1979 article, *Takeover Bids in the Targets Boardroom*, 35 Bus. Law 817, which was the seminal article arguing that the board of directors of a target of a hostile takeover bid could, in the exercise of their business judgment, just say no and take action to prevent the bid’s success. This led to my creation of the “poison pill” in 1982 and the decision of the Delaware Supreme Court in 1985 sustaining the pill and the ability of the board of directors to use it to defeat a hostile takeover.

I was tempted to use this inaugural Davies lecture to update and review my arguments on the issues that surround hostile takeovers. However, they are reflected in much of

the literature on takeovers and corporate governance and I thought it would be more interesting to look at the merger waves of the past and what appears to be a new wave starting in 2003.

Merger Waves

Economists and historians refer to five waves of mergers in the U.S. starting in the 1890s. As I said, I believe a sixth wave started three years ago. The starting date and duration of each of these waves are not specific, although the ending dates for those that ended in wars or financial disasters, like the 1929 crash or the bursting of the Millennium Bubble, are more definite. Indeed, it could be argued that mergers are an integral part of market capitalism and we have had a continuous wave of merger activity that has ebbed and flowed since the evolution of the industrial economy in the latter part of the 19th Century, with interruptions when fundamental forces turned exogenous merger factors negative.

First Period – 1893 to 1904. This was the time of the major horizontal mergers creating the principal steel, telephone, oil, mining, railroad and other giants of the basic manufacturing and transportation industries in the U.S. The Panics of 1904 and 1907, a U.S. Supreme Court decision in 1904 making the recently enacted antitrust laws applicable to horizontal mergers, and then the First World War are pointed to as the causes of the end of the first wave, which some view as continuing beyond 1904.

Second Period – 1919 to 1929. This period saw further consolidation in the industries that were the subject of the first wave and a very significant increase in vertical integration. The major automobile manufacturers emerged in this period. Ford, for example, was integrated from the finished car back through steel mills, railroads and ore boats to the iron and coal mines. The 1929 Crash and the Great Depression ended this wave.

Third Period – 1955 to 1969-73. This was the period in which the conglomerate concept took hold of American management. Major conglomerates like IT&T (Harold Geneen), LTV (Jimmy Ling), Teledyne (Henry Singleton) and Litton (Tex Thornton) were created. Messrs. Geneen, Ling, Singleton and Thornton were viewed as visionaries and heroes of the new concept of business organization. Many major established companies accepted the concept and diversified into new industries and areas. The conglomerate stocks crashed in 1969-70 and the diversified companies never achieved the benefits thought to be derived from diversification.

Fourth Period – 1974-80 to 1989. Generally referred to as the merger wave, or takeover wave, of the 1980s and frequently said to be the period from 1984 to 1989. However, its antecedents reach back to 1974 when the first major-company hostile bid was made by Morgan Stanley on behalf of Inco (the same Inco that has been involved in the four-way takeover struggle that has now ended with its takeover by Vale) seeking to take over ESB. This successful hostile bid opened the door for the major investment banks to make hostile takeover bids on behalf of raiders. In addition to hostile bids, this period was noted for junk bond financing and steadily increasing volume and size of LBOs. In Europe in the latter half of the 1980s companies sought to prepare for the Common Market through cross-border horizontal mergers. In the U.S. this was the period that saw corporate raiders like Boone Pickens run rampant with two-tier, front-end-loaded, boot-strap, bust-up, junk-bond, hostile tender offers until the playing field was leveled by the poison pill in the mid-1980s. However, even after the poison pill, merger activity increased through the latter part of the 1980s, pausing for only a few months after the October 1987 stock market crash. It ended in 1989-90 with the \$25 billion RJR Nabisco LBO and the collapse of the junk bond market, along with the collapse of the savings and loan banks and the serious loan portfolio and capital problems of the commercial banks.

Fifth Period – 1993 to 2000. This was the era of the mega-deal. It ended with the bursting of the Millennium Bubble and the great scandals, like Enron, which gave rise to the revolution in corporate governance that is continuing today. During the fifth wave companies of unprecedented size and global sweep were created on the assumption that size matters, a belief bolstered by market leaders' premium stock-market valuations. High stock prices simultaneously emboldened companies and pressured them to do deals to maintain heady trading multiples. A global view of competition, in which companies often find that they must be big to compete, and a relatively restrained antitrust environment led to once-unthinkable combinations, such as the mergers of Citibank and Travelers, Chrysler and Daimler Benz, Exxon and Mobil, Boeing and McDonnell Douglas, AOL and Time Warner, and Vodafone and Mannesmann. From a modest \$342 billion of deals in 1992, the worldwide volume of mergers marched steadily upward to \$3.3 trillion worldwide in 2000. Nine of the ten largest deals in history all took place in the three-year period 1998-2000, with the tenth in 2006. Most of the 1990s deals were strategic negotiated deals and a major part were stock deals. The buzzwords for opening of merger discussions were, "would you be interested in discussing a merger of equals." While few if any deals are true mergers of equals, the sobriquet goes a long way to soothe the egos of the management of the acquired company. The year 2000 started with the announcement of the record-setting \$165 billion merger of Time Warner and AOL. However, after a five-year burst of telecommunications, media and technology (TMT) mergers, there was a dramatic slowdown in the TMT sector, as well as in all mergers. It started with the collapse of the Internet stocks at the end of the first quarter followed by the earnings and financing problems of the telecoms. While merger activity in 2000 exceeded 1999 by a small amount by the end of the year, the bubble had burst. The NASDAQ was down more than 50% from its high, many TMT stocks

were down more than 50% (some as much as 98%), the junk bond market was almost nonexistent, banks tightened their lending standards and merger announcements were not well received in the equity markets. So ended the fifth wave, with merger activity in 2001 half of what it was in 2000. To my surprise (and I think to the surprise of most) the sixth wave started just three years later.

Sixth Period. From a low of \$1.2 trillion in 2002 the pace of merger activity has increased to what appears will be a total of \$3.4 trillion by the end of 2006. Among the principal factors are globalization, encouragement by the governments of some countries (for example, France, Italy and Russia) to create strong national or global champions, the rise in commodity prices, the availability of low-interest financing, hedge fund and other shareholder activism and the tremendous growth of private equity funds with a concomitant increase in management-led buyouts.

With this brief history of merger waves as background, I'll turn to an analysis of factors that influence merger activity. It should be noted at the outset that macro-economic developments, government policies and other exogenous matters in large measure shape the factors that affect merger activity.

Exogenous Factors Affecting Mergers

Accounting. The availability of pooling accounting for mergers was a significant factor in the 1990s and earlier merger activity. Pooling avoided dilution of earnings brought about by the recognition and mandatory amortization of goodwill when a merger was accounted for as a purchase. Since 2001, purchase accounting has replaced pooling, but goodwill is not amortized and instead is subjected to a periodic impairment test. An impairment charge is taken

when the fair value of goodwill falls below its book value. This method of accounting has proven in many instances even more favorable for mergers than pooling in that it avoids amortization of goodwill and does not saddle the merged companies with the restrictions against share repurchases and asset dispositions that encrusted the pooling rules. Apart from the impact of the accounting rules, acquiring companies have been successful in convincing investors to focus on measurements other than GAAP earnings, such as operating earnings and EBITDA, in evaluating mergers. Thus, accounting today is basically a neutral factor, neither significantly stimulating nor restraining mergers. However, the very large writeoffs of goodwill that were booked in some of the 1990s TMT mergers within a few years of consummation is a cautionary factor.

Activists. A key factor in the sixth wave is the pressure on companies from activist hedge funds and activist institutional investors. Hedge funds are estimated to have more than \$1.2 trillion of capital. Activists are pressuring companies to take action, such as putting the company up for sale, which is adding to merger activity. The role activist hedge funds played and are continuing to play in the competition between the NYSE and Deutsche Borse to merge with Euronext is a cogent example of their power to influence mergers. The ego and boldness of the hedge funds is no better illustrated than by a September 4, 2006 Reuters story:

Knight Vinke Asset Management (KVAM), an investment fund with a small stake in French utility Suez, is confident it can rally enough support to block the planned merger between Suez and state-controlled Gaz de France if the merger terms are not revised.

Eric Knight, who heads the U.S. fund which owns less than 1 percent of Suez, told French daily La Tribune in an interview that it hoped to win support from shareholders representing some 20 percent of Suez's capital and thus block a merger.

In a letter to French Prime Minister Dominique de Villepin published in La Tribune last week, KVAM said it believed the "most obvious solution" would be for Gaz de France to launch a public offer for Suez and to fund it with debt.

KVAM also said it believed Suez was worth at least 40 euros per share but based on GDF's share price, the current Gaz de France offer valued Suez at only 30.07 euros.

Antitrust. Government competition policy can promote, retard or prohibit mergers and is a major factor affecting mergers. The antitrust regulators in the U.S., Canada, the EU and the rest of the world have been reasonably receptive to mergers. They have recognized that markets are global and have accepted divestitures, licenses and business restrictions to cure problems. The "big is bad" concept has been abandoned. The overall situation can be summarized: Current antitrust enforcement policies are not unduly restraining mergers.

Arbitrage. Arbitrageurs continue to be a factor in merger activity, but no longer have the significant role they had in the third and fourth waves, particularly in connection with hostile bids. By providing liquidity for the shares of companies involved in a merger, they make the market more receptive to mergers and thereby facilitate transactions.

Currencies. Fluctuations in currencies have an impact on cross-border mergers. Companies with strong currencies have an advantage in acquiring companies in countries with weak currencies. In the past, and in certain countries today, currency and capital controls inhibit or prevent mergers.

Deregulation. The worldwide movement to market capitalism and privatization of state-controlled companies has led to a significant increase in the number of candidates for merger. The concomitant change in attitude toward cross-border mergers has had a similar effect. Deregulation of specific industries – like financial institutions and utilities – has also contributed to an increase in mergers on a global basis.

On the other hand protectionism has restrained mergers. For example, the Unocal-Chevron-CNOOC and Dubai Ports situations in U.S. and the French government's policy of protecting "national champions" from takeover serve to restrain merger activity. Spain's change of utility regulations (now being disputed by the EU) that enabled ENDESA to reject a bid from German power company E.ON is another example.

It is also interesting to note that Russia has adopted a policy of creating "global champions," which has led to mega mergers in oil and gas (Gazprom) and aluminum (Rusal/Sual) and the failed attempt of Russia's major steel company Severstal to be a white knight and rescue Arcelor from Mittal and thereby become one of the world's largest steel companies. So too the decision last month by the Bank of Italy to encourage the merger of Intesa and Sanpaolo, creating a second world-class Italian bank.

Experts. The development of experts in conceiving, analyzing, valuing and executing mergers has been a significant factor. While some consider this to be phenomenon of the 1980s, it in fact dates to the turn of the 20th Century when JP Morgan merged the Carnegie steel interests with a number of others to create U.S. Steel. The fact that global investment banks are calling merger opportunities to the attention of all the major companies in the world is a merger stimulant. So too the availability of specialized lawyers, consultants and accountants to provide backup and support to the managements and directors of merging companies has been a merger stimulant.

Hostile Bids. During the fifth wave, friendly mergers predominated over hostile takeover activity. Recently, hostile activity has increased. Examples are French building materials group Saint-Gobain's recent \$6.5 billion hostile bid for British plaster board-maker

BPB, Germany's Linde's \$13.4 billion hostile offer for British industrial gasses firm BOC Group, Mittal Steel's \$23.4 billion bid for Luxemburg-based steelmaker Arcelor and Sumitomo Mistui Financial's announcement of its \$29.3 billion unsolicited offer for Japanese bank UFJ Holdings. While UFJ ultimately announced a \$41.4 billion merger with Mitsubishi Tokyo Financial Group, Sumitomo's initial hostile attempt was highly unusual in Japan.

In addition, strategic mergers are not immune from, and may actually attract, third-party attempts to acquire one of the prospective merger partners. The Inco, Phelps Dodge, VALE, TeckCominco, Falconbridge and Xstrata bids here in Canada are a prime illustration.

Labor. While labor unions and employees continue to have a voice in mergers in some countries, it is fair to say that in general employee resistance to mergers is not meaningful in determining merger activity today. However, laws that protect employees from termination or change in work conditions are a deterrent to mergers in those jurisdictions.

LBO Funds. The growth of LBO funds from a humble beginning in the 1970s to the mega-funds of today has been a significant factor in acquisitions. Many funds today have over \$10 billion available and are able to invest \$1 billion or more in a deal. In addition, a phenomenon of the sixth wave is the "club" deal in which as many as four, five or six LBO funds band together. This has enabled the LBO funds to do mega-deals such as the blockbuster HCA and Kinder Morgan deals. Some LBO funds have been making unsolicited bids for companies and some have been joining with activist hedge funds to accomplish acquisitions.

Markets. Receptive equity and debt markets are critical factors in merger activity. During the 1990's merger wave, as stock prices and earnings ratios increased dramatically, the volume of mergers increased dramatically, from \$339 billion of announced

global acquisition activity in 1991 to an all-time high of \$3.3 trillion in 2000. In each year of this fifth merger wave, records relating to merger activity (largest merger, highest volume, etc.) were broken. It looked like the merger wave would roll unimpeded into the new millennium.

The frenetic pace of merger activity then slowed dramatically, the Millennium Bubble burst, and merger activity subsided. Macro-economic factors in large part explain the steep decline in merger activity from 2000 to 2003. Buoyant equity markets created the currency and psychological underpinning of the prior period's merger wave, and an end to their upward surge was the most important factor diminishing the previously high levels of merger activity. As previously noted, by 2003, the NASDAQ had fallen approximately 70% from its high in 2000, and many Internet, telecom and technology stocks were down more than 75% (and some as much as 98%) during the same period. In 2002, stock, which in the 1990s had been the acquisition currency of choice, made up a smaller percentage of total deal consideration in the U.S. than for any year since 1997. Moreover, the weakened economy in the U.S. and other nations, compounded by the tragic events of September 11, 2001 and subsequent domestic and international conflict, as well as questions regarding accounting and corporate governance practices in the wake of the Enron-type scandals, further reduced investor and made the markets less receptive to mergers.

Nonetheless, merger activity did not grind to a complete stop. Despite lingering concerns regarding deficits, terrorism and corporate governance, improving market conditions, coupled with increased optimism regarding the North American and European economies generally, created a more conducive macroeconomic environment for merger activity in 2004 and 2005. Indeed, in the last three years, the market has seen a notable increase in deal activity, including a mix of strategic business combinations and financial sponsor motivated transactions,

in both friendly and hostile contexts. In 2004 global merger activity reached \$1.8 trillion and in 2005 it reached \$2.6 trillion.

Deal activity through the first eight months of 2006 has been a continuation of the 2004 and 2005 trend. Key enabling factors for recent increases in deal activity include strong growth in corporate profits and available cash, return of confidence in the boardroom, relatively low interest and inflation rates, readily available debt financing in historically unheard of size and the growing pools of investment capital being deployed by private equity funds and hedge funds in acquisition transactions.

New Companies. Just as the explosive formation of new companies in the latter part of the 19th Century fueled the first and second merger waves, the recent formation of thousands of new companies in the technology areas fueled the fifth wave and is continuing to be a major factor in the sixth wave.

Taxes. In general transaction taxes have not been a significant factor in global merger activity.

Autogenous Factors Affecting Mergers

The foregoing external factors are essentially beyond the ability of companies to control or even to influence significantly. While they basically determine whether a particular merger is doable at a particular time, they do not explain why companies want to merge. What are the internal business reasons driving merger activity? There is no single or simple explanation. Experience indicates that one or more of the following factors are present in all mergers:

Obtaining market power. Starting with the 19th Century railroad, steel and oil mergers, a prime motivation for merger has been to gain and increase market power. Left unrestrained by government regulation it would be a natural tendency of businesses to seek monopoly power. In the U.S. the 19th Century Interstate Commerce Act and Sherman Antitrust Act were the governmental response to the creation of trusts to effectuate mergers in the basic industries.

Sharing the benefits of an improved operating margin through reduction of operating costs. Many of today's acquisitions involve a company with a favorable operating margin acquiring a company with a lower operating margin. By improving the acquired company's operations, the acquiror creates synergies that pay for the acquisition premium and provide additional earnings for the acquiror's shareholders. Acquiring firms may reallocate or redeploy assets of the acquired firm to more efficient uses. Additionally, intra-industry consolidating acquisitions provide opportunities to reduce costs by spreading administrative overhead and eliminating redundant personnel; this has been a major factor in bank mergers.

Sharing the costs and benefits of eliminating excess capacity. The sharp reductions in the U.S. defense budget in the early 1990s resulted in defense contractors consolidating in order to have sufficient volume to absorb fixed costs and leave a margin of profit. The Defense Department encouraged the consolidations to assure that its suppliers remained healthy. The pressure to control healthcare costs has had a similar impact in the healthcare industry. The mega-mergers of, and joint-venture consolidation of refining and marketing operations by, oil and gas companies is another example of an effort to reduce costs.

Integrating back to the source of raw material or forward to control the means of distribution. Over the years vertical integration has had a mixed record in actually achieving value creation. Currently it has a poor record in media and entertainment, particularly where “hardware” companies have acquired “software” companies. However, vertical integration continues to be a motivation for a significant number of acquisitions, and, as noted below, is being widely pursued as a response to the Internet.

The advantage or necessity of having a more complete product line in order to be competitive. This is particularly the case for companies such as suppliers to large retail chains that prefer to deal with a limited number of vendors in order to control costs of purchasing and carrying inventory. A similar situation has resulted in a large number of mergers of suppliers to the automobile manufacturers.

The need to spread the risk of the huge cost of developing new technology. This factor is particularly significant in the aerospace/aircraft and pharmaceutical industries.

Response to the global market. The usual and generally least risky means of increasing global market penetration is through acquisition of, or joint venture with, a local partner. Due to the increased globalization of product markets, U.S. cross-border merger and acquisition activity has been steadily increasing. Many of the most important and largest product markets for U.S. companies have become global in scope.

Response to deregulation. Banking, insurance, money management, healthcare, telecommunications, transportation and utilities are industries that experienced mid-1990s mergers as a result of deregulation. Examples are the acquisition of investment banks and insurance companies by commercial banks following the relaxation of restrictions on activities

by commercial banks, and the cross-border utility mergers following the relaxation of utility regulation and the privatization of utilities in a number of countries.

Concentration of management energy and focus. The 1990s witnessed a recognition by corporate management that it is frequently not possible to manage efficiently more than a limited number of businesses. Similarly, there has been recognition that a spinoff can result in the market valuing the separate companies more highly than the whole. These factors resulted in the spinoff or sale of non-core businesses by a large number of companies.

Response to changes in technology. Rapid and dramatic technological developments have led companies to seek out acquisitions to remain competitive. Cogent examples are the acquisitions by telephone, software, cable and media companies designed to place them in a position to compete in an era of high-speed Internet access via cable in which people interact with the World Wide Web for news, information, entertainment and shopping.

Response to industry consolidation. When a series of consolidations takes place in an industry, there is pressure on companies to not be left out and to either be a consolidator or choose the best partner. Current examples of industries experiencing significant consolidation are banking, forest products, food, advertising and oil and gas. Size has a major impact on a company's price earnings multiple. Larger companies have significantly higher multiples than smaller companies with the same growth rate.

The receptivity of both the equity and debt markets to large strategic transactions. When equity investors are willing to accept substantial amounts of stock issued in mergers and encourage deals by supporting the stock of the acquiror, companies will try to create value by using what they view as an overvalued currency. When debt financing for acquisitions

is also readily available at attractive interest rates, companies will similarly use what they view as cheap capital to acquire desirable businesses.

Pressure by activist shareholders to increase shareholder value. As already noted, activist hedge funds and institutional investors have had considerable success in urging (and sometimes forcing) companies to restructure or seek a merger. The enhanced ability of shareholders to communicate among themselves and to pressure boards of directors has had a significant impact. Boards have responded by urging management to take actions designed to maximize shareholder value, resulting in divestitures of non-core businesses and sales of entire companies in some cases. In other cases, shareholder pressure has been the impetus for growth through acquisitions designed to increase volume, expand product lines or gain entrance to new geographic areas.

Less management resistance to takeovers. The recognition by boards of directors that it is appropriate to provide incentive compensation, significant stock options and generous severance benefits has removed much of the management resistance to mergers. So too the ability of management to obtain a significant equity stake through an LBO has been a stimulant to these acquisitions.

Disregard of the supposed high rate of merger failure. Most academic studies of mergers argue that a majority of mergers are not beneficial to the acquiring company. Yet companies continue to pursue mergers. Some argue that management aggrandizement is the reason. However, apart from this explanation and apart from a management belief that the deal of the moment will not be one of the failures, the academic studies are criticized and largely ignored on the grounds that they are mostly based on comparing the stock market value of the

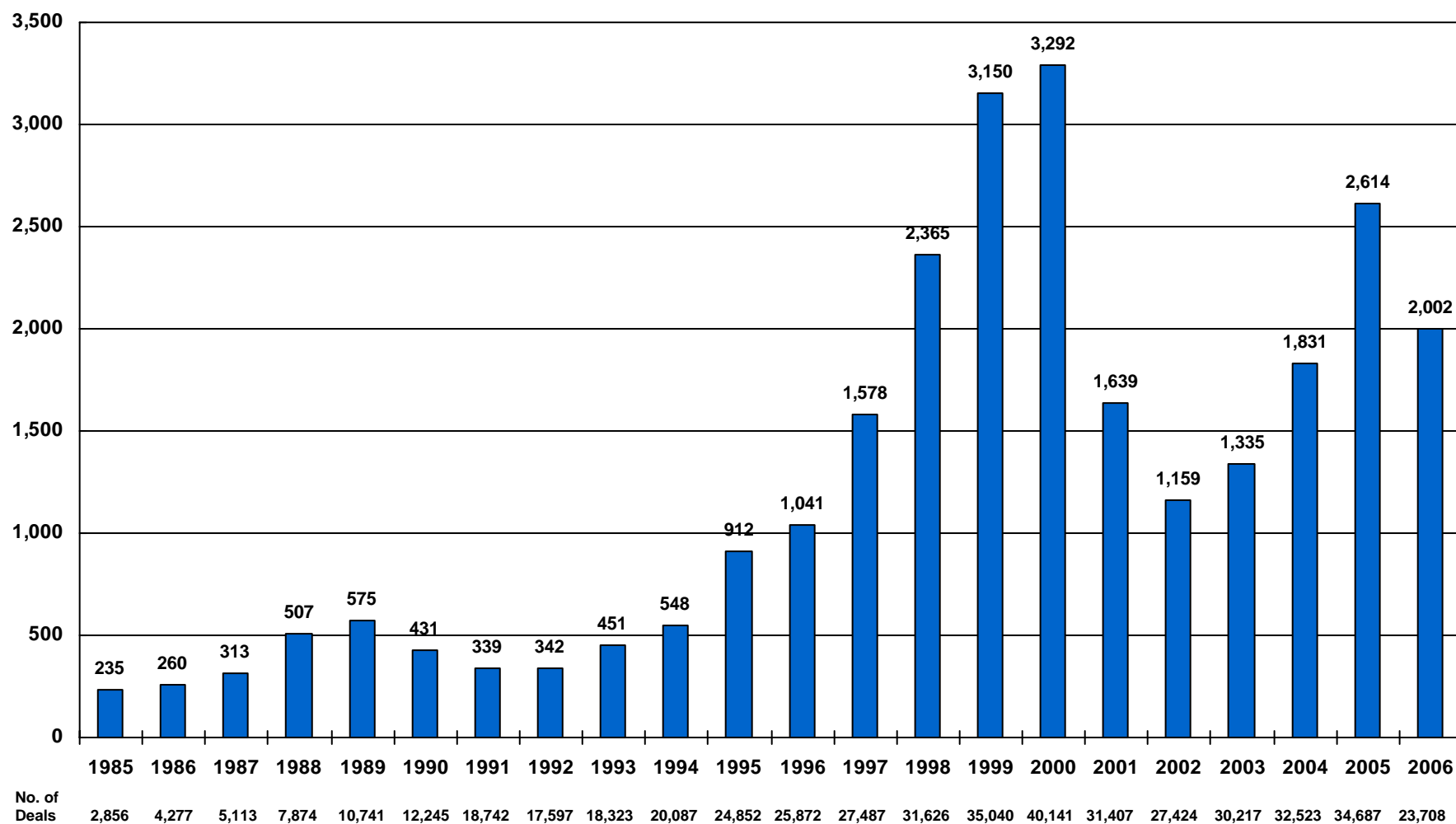
acquiring company to that of its peers or the general index for periods subsequent to the acquisition. The obvious defect in this analysis is lack of information as to how the acquiror would have fared if the acquisition had not taken place. Personal experience confirms a substantial number of failed mergers; however, my experience does not confirm the academic studies. The majority of negotiated strategic mergers that I have been involved in were successful for the acquiring company. The same cannot be said for hostile takeovers where the culture clash usually results in management disruption that causes failure. The December 27, 2000 Lex Column of the *Financial Times* summarized the “right recipe” for a merger:

So what do investors want from an acquisition? The answers are much the same as they always were: deals which do not blur the lines of responsibility in an attempt to create a merger of equals; which do not serve principally the aggrandisement of the chief executive; which have some more compelling strategic rationale than merely to achieve scale in a consolidating industry; and above all, deals which create more value through the synergies they unlock than they give away in premiums paid to the target’s shareholders. If possible, could they please also have some real prospects for revenue growth in the mixture, as well as just cost cuts?

Worldwide M&A Environment

Global Announced M&A Activity — 1/1/1985 – 9/5/2006*

Deal Value
(\$ Mil)

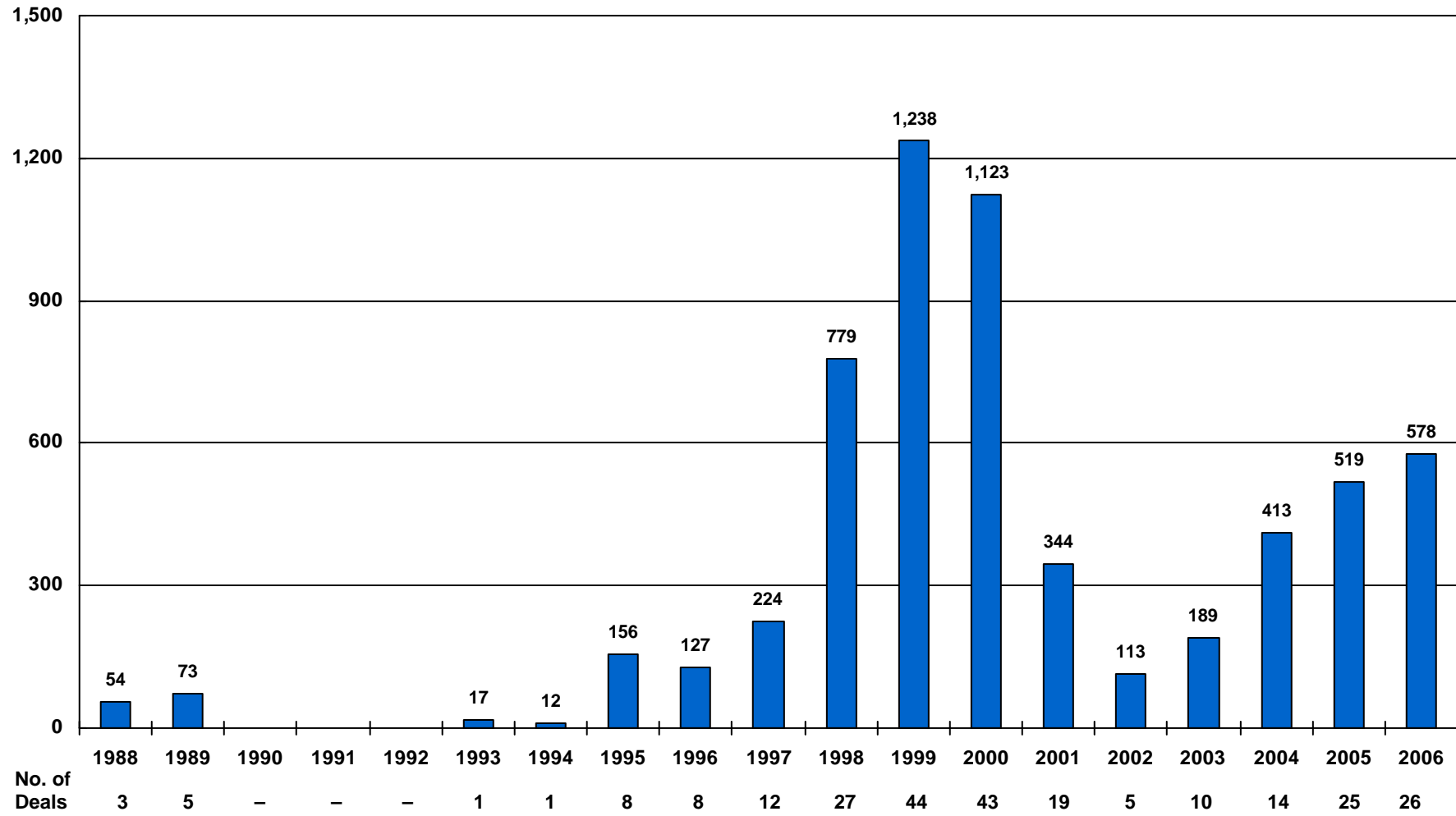


Source Thomson Financial as of September 5, 2006
* Excluding Withdrawn Deals and Open Market Repurchases

Worldwide M&A Environment

Global Announced M&A Activity of \$10 Bn or More — 1/1/1988 to 9/5/2006*

Deal Value
(\$ Mil)

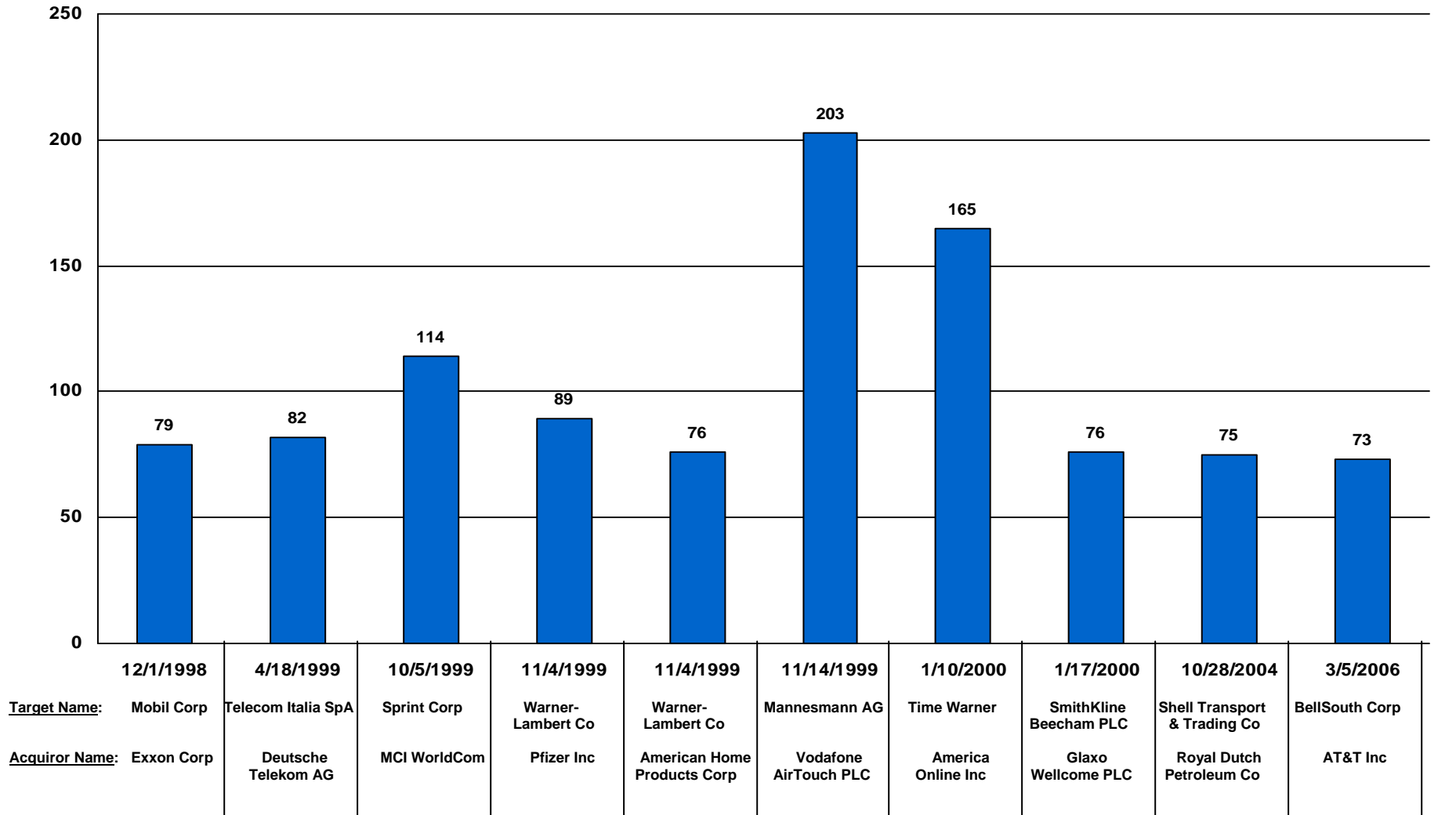


Source Thomson Financial as of September 5, 2006
* Excluding Withdrawn Deals and Open Market Repurchases

Worldwide M&A Environment

Top 10 Deals Worldwide

Value of Transaction
(\$ Mil)



Source Thomson Financial as of September 5, 2006

Worldwide M&A Environment

Top 10 Deals Canada

**Value of Transaction
(\$ Mil)**

