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Conglomerates and Takeovers

It is altogether important that the whole financial community and the Commission of which I am a member have a meaningful dialogue on the major policy matters facing the securities business today. While I am a speaker at the moment, I would like you to know that my colleagues and I are also quite capable of listening well. Certainly our congressionally mandated efforts to protect public investors should be based on a real-time knowledge and appreciation of the practicalities of your business. Our response to changes in your ways of doing business and to the appearance of new institutions and techniques must be informed and measured. Even if you put us in the frying plan, or we put ourselves there, we don't want you, us or the country to jump into the fire.

Our securities markets have functioned well enough to become vitally important to our nation and the admiration of the western world. Any adjustments in their operations must be carefully administered, both by you for your entrepreneurial objectives and by us for our regulatory responsibilities. None can deny that the enormous changes going on in the financial world will result in adjustments. And I am sure that none will contest that the welfare of public investors and the national interest must remain paramount for both you and us alike. Indeed, I am confident you would want it so, and will want to help us make the best decisions to achieve the public interest.

Now there are today a number of things I could well have chosen to talk with you about. The back-office problem and its many-level solutions need constant emphasis -- it is in fact priority number one. Nevertheless, I decided to talk about another matter to which we have continual exposure. While a number of policy issues involved are outside our scope as an agency, it is one in which the financial community has an interest. That is the subject of conglomerates and takeovers. I add that these are my own observations, drawn from a variety of sources.

It isn't difficult to establish the subject as being current. There has hardly been a recent edition of a newspaper or magazine in which some member of the financial press has not only reported but also extensively commented on conglomerates or corporate takeovers or, more often, both. Most of the alphabet agencies of the government are faced currently with the phenomenon: not just the FTC and SEC, but as conglomeration has reached into the regulated industries, also the FCC, the CAB, the FRB and the ICC. The Justice Department is taking a renewed look at the development and the Treasury and Comptroller are concerning themselves with bank involved conglomeration, the one-bank holding company. Also, and certainly not least, the Congress -- both houses -- have had their interest and concern aroused. I believe it is four separate committees of the House that have held or called hearings on one or another aspect of conglomerates. The Senate committees have also been active. A number of legislators have spoken on the floor and elsewhere voiced apprehension. Our new Commission chairman has already been asked to testify on aspects of the subject before a number of committees.

Nor is it difficult to see why there is such attention to the subject. There has been an almost continuous merger movement in our economy since the end of World War II, particularly since the early 1950's, making it the longest lived in our national history. Rather than subsiding, the year before last, 1967, marked the largest number of recorded mergers in manufacturing in any year till then, topping even 1899 and 1928. And last year, 1968, was 35 percent larger than 1967, making it by a wide margin the all-time record year. According to the FTC, although the significance and meaning of the statistics are contested, in 1968 ninety percent of the the assets acquired in all acquisitions of companies with assets of $10 million or more were conglomerate in form.

There is, I believe, a second factor in the arousing of attention -- the combined facts that an increasing number of acquisitions are not particularly friendly and that the size of the target companies has grown. It is unrealistic to think that managements of large target, or potential target, companies who want to resist takeover attempts would fail to point out to all three branches of the government the policy issues they see involved in such activity. And in the background, or maybe not in the background, is the fear -- some call it real, others

call it unreasoning, yet others say it's inevitable -- that the movement will lead to an economy in which the country's productive machinery would be controlled by a few hundred super-corporations, like the Japanese zaibatsus. So no question about it, the subject is alive and many questions are being asked about the newly intensified phenomenon of conglomeration, the popular practice of combining diverse, if not divergent, enterprises into a hopefully viable economic organization.

You might think that by this time everyone would know what a "conglomerate" is. Yet there are hotly contested arguments about that, largely I suppose because the term has become too pejorative for those who defend the development or too imprecise for those who seek to be as objective as possible in their analysis of it.

This latter motivation led Professor Mautz, in his comprehensive study on financial reporting published last year by the Financial Executives Institute, to use the term "diversified companies." That term was also preferred by the Accounting Principles Board in its 1967 release on disclosure of supplemental financial information. For purposes of financial reporting, Professor Mautz treated as a diversified company one that either is so managerially decentralized, so lacks operations integration, or has such diversified markets that it may experience rates of profitability, degrees of risk and opportunities for growth which vary within the company to such an extent that an investor requires information about these variations in order to make informed decisions.

With some variation that essentially is the definition the SEC proceeded on in proposing its new rules for disclosure by companies which in our words are "engaged in more than one line of business." We said that in grouping products or services as lines of business appropriate consideration shall be given to all relevant factors, including rates of profitability of operations, degrees of risk and opportunity for growth.

I'll come back to our pending requirements later, but you'll note that these financial reporting definitions do not relate to how the conglomeration or diversification occurred, whether by internal growth or external acquisition.

The Federal Trade Commission, on the other hand, has made use of the word conglomerate in defining the type of acquisition or merger that is neither horizontal (between competitors) nor vertical (between supplier and manufacturer or manufacturer and distributor). Horizontal and vertical mergers dominated the two earlier major movements in American industrial history, the first of which peaked around the turn of the century and the other in the late 1920's. As the Director of the FTC Bureau of Economics has pointed out, there were some "conglomerate" mergers in the 1920's, but these were of either the product extension or market extension type, unlike the "free form" type that predominates today. Mr. Houghton called a conglomerate "a firm which is engaged in a number of industrial activities serving more or less distinct markets," and said

> It's a question of degree. It could be said that the less a firm is dependent on any one or a few lines of activity for its economic welfare and the longer and wider the number of its products or its geographic markets, the more conglomerated it is.

Thus, for the FTC's purposes of maintaining competition, and of studying in depth, as they are presently doing, the economic efficiency justification for the reduction in number of independent business units that conglomeration results in, there is again a certain vagueness or flexibility in defining the phenomenon.

Conglomerates have been given another suggestive description that bears some pondering. Someone has called them "mutual funds with smokestacks."

There is at least an analogy, and perhaps a correlation, between the institutionalization of investors and the conglomeration of corporations. There is certainly a time span coincidence between the concentration of investment decision-making into the hands of managers of larger and larger capital funds, and the concentration of capital allocation decision-making into the hands of managers of larger and larger conglomerates. At the same time that individual investors were purchasing diversification in mutual funds, they, and the institutional investors, were voting their approval of or accepting tender offers for diversification in conglomerates.

As fund managers are allocators of external equity among a wide range of choices, so conglomerate managers are in a primary sense allocators of internal equity among a now wide range of choices. Both movements are big. In the last eight years, since 1960, investment company assets grew by $46 billion and the assets of conglomerate companies grew by about $30 billion.

The almost side-by-side occurrence of institutionalization in the securities markets and conglomeration in industry is some indication that there may be underlying motivations in our society that have produced them both. For example, both funds and conglomerates rely and promote themselves on managerial professionalism and attention to technological innovation. This in turn reflects the unique contribution of this country's business schools to the industrial, or some call it post-industrial system. In inquiring into institutionalization and conglomeration, any thoughtful treatment will have to take account of the immense educational substructure that is creating the new managerial class and teaching in effect that principles of management are not limited to a particular business. Account will also have to be taken of the implications of the computer technology that significantly expands management's capabilities for both internal and external investment. Some commentators have focused on the colorful individuals in charge of some of the more aggressive conglomerates. I am suggesting there is more to the phenomenon than personality.

I readily acknowledge that analogy or correlation, such as I have suggested between institutionalization and conglomeration, is not analysis, and can be carried too far -- there are differences. And so I will only point out one other possible connection.

It may be that the existence of large portfolio positions in some institutional hands has facilitated the ability of conglomerates to acquire companies held in those portfolios. The current emphasis by many institutions on short-term performance results probably does lead to a special receptivity on their part to the instant capital appreciation that the public tender offer techniques produce. I could imagine that it might become a concern for corporate issuers when they see substantial institutional stockholdings develop in their company -- a very different reaction from the prior, almost universal satisfaction of management about "strong" institutional interest in their securities.

There is even an interesting definitional question with which the Commission has been confronted. If a corporation falls within one of the technical definitions of an investment company in the 1940 Act, it becomes subject to all the requirements of the 1940 Act, including its rigid and detailed provisions regulating capital structure. Where any corporation owns or proposes to acquire "investment securities" having a value exceeding forty percent of the value of its total assets, it may fall within the investment company definition. Particularly when a smaller company acquires securities of a larger company and is not controlling and directing the affairs of the target company, we are faced with the question whether this aspiring conglomerate has become an investment company. The question might be framed as whether the conglomerate has lost its smokestacks.

The corporate financial landscape does take on a curious aspect when viewed through its tiers of financial intermediation. It serves to show the distance we have traveled from the days when the only non-farming investment opportunity for someone who had saved, would either be in his own business, or in another single product-local market enterprise, almost always owned and operated by someone he knew. Today a saver might purchase shares in a mutual fund (or even a financial vehicle that in turn purchases mutual fund shares). The mutual fund, in its turn, in addition to allocating its portfolio through a number of industries, invests a significant portion of its assets in conglomerate companies. They in their turn allocate their capital through a number of industries. Thus the distance from saver to ultimate investment in real assets is lengthened, and the role and complexity of the intervening financial assets are enlarged. Whether that is the ultimate in economic efficiency or in investment risk aversion I don't know, but it's a profound fact that underlies today's discussions.

The questions are not simple -- nor do they suggest simplistic treatment. At least until all the evidence is in, it would seem premature to me, to lump all conglomerates together and say bad. The SEC's concern, of course, does not reach the broader economic policy questions encompassed in the antitrust and tax laws or in the substantive statutes regulating particular industries.

In the securities industry we may have, in a sense, our version of the conglomerate problem bound up in the questions of institutional membership on the exchanges and public ownership of member firms. But those questions also involve other considerations and I assume they will be dealt with systematically and in a studied manner in the course of the pending commission rate structure proceeding.

In any case, the current focus is on industrial conglomerates and the way they are being assembled. The Commission's contact with the current conglomerate phenomenon occurs at several junctures. I'll refer to just two.

The first occurs when a tender or exchange offer is made. If securities are being offered in exchange for those of a target company, the tenderor must file a registration statement under the Securities Act of 1933 which provides information not only about the tendering company but also the target company. The offer cannot be made until the Commission declares the registration statement effective. When cash is being offered, the tendering company must immediately upon announcing the tender offer file with the Commission an information statement under the 1968 takeover legislation. Under either procedure the news of the impending takeover bid is likely to hit stockholders and investors generally with trip-hammer suddenness.

The announcement of a tender offer is generally accompanied by a dramatic rise in the price of the target company's securities, considerable market activity by speculators and arbitrageurs, and general confusion on the part of the target company's stockholders and employees. If one of the purposes of the securities legislation is to make the investment decision as rational a one as possible, it is difficult to imagine an atmosphere less conducive to rational thinking than the heat and haste generated by tender offers. Particularly where complex securities packages are being offered, the time generally provided for investors to reach a decision hardly seems sufficient. And the pressure on the management of the target company to present its case in time to offset the impact of surprise is enormous and somehow to me hardly contributes to investor decision on the merits.

A number of us view with concern the use of complex securities or complex packages of securities in takeover bids. Today a typical exchange offer might consist of a proposal to issue a package of securities consisting of:

(1) $45 principal amount of subordinated debentures, often bearing a curious rate of interest,

(2) 3/5ths of one share of a preferred stock, that has no public market, and

(3) 3/10ths of a five-year warrant to purchase one share of common stock, at a specified price other than current market,

all in exchange for <u>two</u> shares of common stock of the target company.

Such a package must be a little difficult to evaluate!

The stockholder of a target company may also have trouble evaluating the relative rights of the securities being offered to him -- relative to those of the other outstanding securities of the acquiring company. To cite an example of the sort of analytical problem facing stockholders, a prospectus filed with the Commission by one conglomerate company contains a five page capitalization table, including detailed footnotes.

A security with a conversion feature has been increasingly used in an exchange offer, and such a feature may be difficult to evaluate. Of the $11.2 billion securities registered for the purpose of exchange offers in 1968, $4.8 billion represented convertible bonds and convertible preferred stock, compared to $4.6 billion in straight common. The trend is toward the use of convertible bonds. In the last quarter of 1968, securities in the amount of $3.2 billion were registered in connection with exchange offers, of which $1.7 billion, or more than half, represented convertible bonds.

The convertible debt securities appear to have the advantages of both debt and equity positions, but as Chairman Budge pointed out, it should not be forgotten that they may have some of the disadvantages of both. If a conglomerate continues to expand via the debt-leverage route, it may impose new classes of senior securities ahead of the current issue and become so heavily leveraged that the security offered by a debt position becomes illusory. The advantage of the conversion privilege may also prove illusory, both because inflated expectations for future growth of the acquiring company may have

been created by the current acquisition techniques, and because the security holder may not realize the potential dilution if other convertible security holders convert into shares of the same class. Moreover, in some convertible debt issues it just seems impossible that the debt could be paid off as debt.

The increasing use of debt for acquisitions is also true in cash tender offers. In the 45 cash tender offers filed with us between August and the end of February, $1.1 billion of the total $1.4 billion offered was financed by bank loans.

One consequence of the increase in debt financing is that companies with free liquid assets have become popular as targets for takeover bids. Such assets can be pledged by the acquiring company to secure funds for further acquisitions, or to partially liquidate loans made to acquire the target company. While high debt-equity ratios are not necessarily bad, they are legitimate cause for concern if the reason for incurring long-term debt risk is to achieve short-term capital appreciation in a company's stock by structuring a glamorous earnings multiple.

That brings us to another point of Commission contact with conglomeration -- in the resulting financial statements of a conglomerate company, both in the accounting treatment given to the acquisition or merger, and in the disclosure of income information with respect to the acquired business after the acquisition is consummated.

The accounting treatment problem relates to whether the companies are combined for accounting purposes through the "pooling-of-interests" method or the "purchase" method. If the former method is used, the financial statements of the two companies are, in substance, added together with no reflection in the accounts of any cost of acquisition, even where one of the pooled corporations is nine or ten times the size of the other. If the acquiring company has a higher price earnings ratio than the acquired company, the mathematical result is that the combined enterprise will show an increase in earnings per share, although there has been no improvement in real earnings. The best we or the accounting profession has so far been able to do with this mathematical result of pooling

on computation of earnings per share is to require a "pooling back." This puts the prior year's per share earnings on the same basis as the present year's, having the mathematical effect of increasing the prior years also, and thereby flattening out what would otherwise be a sharp upward trend in earnings per share. The Accounting Principles Board is hard at work on earnings per share right now.

Unfortunately, the purchase method is not without its problems either. The amount paid for the target company is nearly always greater than the book value of its assets. The difference is treated in the accounts as goodwill, and the problem becomes what to do with the often large intangible item. Accountants argue over whether goodwill can be left on the books forever, must be written off immediately against surplus, or must be amortized over some period of time. The pooling-purchase accounting problem is currently being worked on intensively by the Accounting Principles Board and we have a deep interest in a proper result there.

The problem with regard to future disclosure of information about the acquired business is the subject of the Commission s proposed amendments to Forms S-1, S-7 and 10. The revised forms would provide investors with useful financial information about the important components of a conglomerate enterprise. Briefly stated, the proposed amended forms would require diversified companies to disclose for each of a maximum of five fiscal years beginning with 1967 the approximate amount or percentage of (1) total sales and operating revenues and (2) contribution to income before income taxes and extraordinary items attributable to each line of business which contributed, during either of the last two fiscal years, ten percent or more to (1) the total of sales and revenues, or (2) income before income taxes and extraordinary items. Similar disclosure is also required with respect to any line of business which resulted in a loss of ten percent or more of such income before deduction of losses. Where the number of lines of business exceeds ten, the disclosure may be limited to the ten most important lines.

The amended forms when adopted (which should be soon) should help to provide investors with information about conglomerates needed to test in part the validity of an often cited reason for their creation, the theory of synergism. In its corporate context this theory implies that the total capabilities of a conglomerate exceed those of the sum of its constituent parts. That sounds impressive, a little mysterious perhaps. The proposed forms are a step in the direction of removing some of the mystery by providing information about the parts.

Thank you.