

The Merger Boom: An Overview

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Battles for corporate control have increasingly attracted the public spotlight. This attention reflects not only the growth in the number of acquisitions in the 1980s but also the size of the targets. Firms previously thought too large to be takeover targets have been acquired despite active management opposition.

Any acquisition, and particularly one involving sizable assets, is likely to result in disruptions. Employees may be reassigned or laid off, suppliers may be changed, investment programs may be cut back. The prospect of such changes may encourage those threatened by acquisitions to form a coalition with current management in supporting such defensive strategies as restrictive corporate charter amendments, anti-takeover legislation, and active litigation. These takeover battles and the resulting increase in public interest in takeovers have led policymakers and academics to consider whether current takeover procedures appropriately balance all the competing interests.

In the fall of 1987 the Federal Reserve Bank of Boston brought together financial economists, industrial organization specialists, government officials and representatives of the business and investment communities to examine the reasons for the current merger and acquisition wave, the implications for economic performance, and the appropriate public policy responses. At the conference, *The Merger Boom*, two views of mergers and acquisitions and two approaches to the study of mergers were represented.

Financial economists, relying on stock market data and portfolio models, generally have a positive view of mergers and acquisitions. The

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increase in acquisitions in the 1980s is seen as part of a necessary restructuring of U.S. corporations leading to greater efficiency and higher productivity. The gains from this restructuring are evidenced in the large increases in the stock prices of acquisition targets when acquisition attempts are announced. New techniques for valuing corporations and new financing mechanisms have contributed to the rise in acquisitions, especially hostile takeovers, by subjecting managers to close scrutiny and by enabling prospective acquirers to attract funds quickly. Restrictions on takeovers would prevent efficiency-enhancing restructuring and should therefore be opposed.

Industrial economists, on the basis of accounting data and models of market structure, are skeptical of the efficiency gains that their finance colleagues claim for acquisitions. Acquirers and investors may expect to realize efficiencies but these expectations are often unrealistic. According to the industrial economists, most acquisitions are unsuccessful in terms of increasing profitability and market share; transition costs associated with the merger tend to reduce hoped-for gains. The industrial organization economists also suggest that management empire-building and attempts to acquire market power, rather than efficiency gains, may motivate many acquisitions. In attempting to explain the recent upsurge in acquisitions, they emphasize the effects of more liberal antitrust enforcement and the reshuffling of assets acquired in the conglomerate merger boom of the 1960s. The breakup of diversified companies formed in past merger booms is also seen as confirmation that mergers are not productive.

The conference brought together representatives of these two disparate viewpoints in the hope of clarifying the nature of their differences and identifying areas of agreement. The major conclusions of the conference were as follows:

- The current merger and acquisition boom has many causes. The pressures of international competition, financial innovations, and more liberal antitrust enforcement, as well as other factors, have all contributed.
- The current acquisition boom differs from past merger booms, both in its causes and in the forms of acquisition. While diversification was an important motive for mergers in the 1960s, the current boom has been characterized by a large number of "bust-up" takeovers, or takeovers of diversified companies with the object of selling the component pieces. The current boom is also unusual in the large size of the acquisition targets and in the prevalence of hostile takeovers, management buyouts, and debt-financed acquisitions.
- Shareholders of target companies gain from acquisition attempts. The increases in share prices are at least as large, if not larger, for targets of hostile takeovers as for acquisitions that have target management's

support. The source of these gains to target shareholders remained an open question. The finance economists attributed the gains to efficiencies resulting from the acquisitions, but conceded that there may be alternative explanations. The industrial organization economists argued that mergers are unproductive and therefore that efficiency gains cannot be the sources of the returns to target shareholders. Gains to target stockholders may reflect inflated prices paid by the acquirer, resulting from unrealistic expectations about potential gains from mergers.

- Restrictions on hostile takeovers are misguided. The finance economists were strongly opposed to corporate antitakeover defenses and state laws restricting hostile takeovers, seeing them as protecting ineffective management and preventing desirable restructuring. Industrial organization economists, while disputing that acquisitions lead to efficiency gains, did not favor takeover restrictions. They were reluctant to protect incumbent management or deny target shareholders the large increases in share prices that takeovers produce.
- More research should be devoted to determining how managerial incentives may be used to resolve conflicts between management and shareholders. Such conflicts are especially acute when a company is a takeover target, as incumbent management is likely to be displaced. Conflicts may also arise from the opportunity to make acquisitions, as compensation packages tied to company size may reward unproductive empire-building.
- The research techniques of the finance and industrial organization fields should be brought together. Reconciling the existence of large gains to target shareholders with the disappointing postmerger performance of merging firms requires the data and research approaches of both fields. Until such reconciliation takes place, finance and industrial organization economists, despite areas of agreement, will continue to view mergers and acquisitions very differently.

This article provides an overview of the seven conference papers and discussants' remarks. Particular emphasis is placed on areas of difference and agreement that recurred throughout the conference. The first three papers examined the reasons for the current merger wave. The fourth and fifth papers addressed the effects of mergers and acquisitions, focusing on whether acquisitions result in efficiency gains. The final two papers considered public policy implications of the recent increase in acquisitions. A brief conclusion follows the overview.

Motivations of the Current Merger Boom

What are the motivations behind the present upsurge in mergers

and acquisitions? The answer depends, in part, on whether the question is asked of someone with a finance or an industrial organization perspective. The first paper, by David Ravenscraft of the University of North Carolina, offered an industrial organization perspective.

Expectations and Merger Waves

Ravenscraft introduced themes that recurred throughout the conference: there are many motivations for mergers and, therefore, many factors responsible for a merger wave; the current merger wave differs from past waves in a number of respects, including the increased use of hostile tender offers and the large size of takeover targets. However, Ravenscraft's central points were, first, that merger waves reflect changing expectations of the gains from mergers and, second, that expectations of efficiency gains from mergers are likely to be disappointed. Although the stock market reacts positively to merger announcements, bidding up the stock prices of target companies, Ravenscraft argued that mergers and acquisitions do not improve the postmerger performance of combining firms. A merger wave begins when some combination of circumstances convinces investors and potential acquirers that acquisitions will be more productive than they were in the past. The wave subsides as it becomes apparent that the expected gains are not materializing.

Most research on earlier merger waves emphasized the importance of business cycle variables such as low interest rates, which reduce acquisition costs, and high stock prices, which may reflect expectations of higher earnings. However, the merger wave of the 1980s continued through two recessions and two expansions, during which interest rates and stock prices varied greatly. Thus, Ravenscraft argued, the current wave cannot be explained by fluctuations in cyclical variables. Instead, he emphasized the effects of less restrictive antitrust enforcement and the deregulation of certain industries.

Not only have antitrust guidelines become less restrictive in recent years, but also the government has challenged borderline cases less frequently. Major regulatory changes have occurred in the banking, transportation, communication, and oil and natural gas industries; as a consequence, firms that were insulated from competition by regulation are now forced to operate more efficiently. While the relaxation of antitrust barriers made possible acquisitions that were previously prohibited, Ravenscraft thinks that the primary significance of antitrust and regulatory changes was to cause managers and investors to revise upwards their expectations of the gains from acquisitions. In other words, a changed environment has persuaded potential acquirers and their financing sources that acquisition opportunities have improved and that the mistakes of the past will not be repeated. The merger wave will

continue until these expectations are disappointed.

Discussion: Need for Restructuring

John Paulus, chief economist of Morgan Stanley & Co., took issue with Ravenscraft's negative assessment of acquisitions, arguing that mergers and acquisitions do indeed result in efficiency gains. While agreeing that mergers have many motivations, Paulus attributes much of the recent increase in acquisition activity to intensified competitive pressures, which have created a need for restructuring. These pressures have arisen in manufacturing because of increased foreign competition and in mining, banking, and various other industries because of deregulation. Competitive pressures have led to changes in internal operations as well as to mergers and acquisitions in the affected industries. In contrast to Ravenscraft, Paulus believes that expectations of efficiency gains from acquisitions will be fulfilled. Paulus cited productivity improvements in the industries subject to restructuring as evidence of the beneficial effects of merger and acquisition activity.

Paulus expects the acquisition boom to continue and to extend to the services industries as the falling dollar redistributes income away from services and increases competitive pressures in this sector. He predicted that leveraged buyouts, or acquisitions relying predominantly on funds raised in the bond market, would figure prominently in future acquisition activity. Leveraged buyouts frequently alter the way a firm is managed. Since most of the firm is financed by debt, management's immediate objective is to maintain a cash flow that can pay the interest and some of the principal. In leveraged buyouts in which senior management is an owner or creditor, management has strong incentives to cut waste and run the firm efficiently.

Discussion: Acquirers' Motivations

Robert Henderson, drawing upon past experience as the chief executive officer of Itek, an acquisition target, agreed with Ravenscraft that the motivations and expectations of the acquiring management are central to understanding mergers. He argued that acquiring management can always find some hoped-for efficiency gain to justify a merger. However, the difficulties of combining corporate cultures, as well as the unforeseen problems, cause most mergers to be less successful than expected. Making a merger work is difficult, even when a good fit appears to exist between the target and the acquirer. The current acquisition boom, particularly the increase in divestitures and bust-up takeovers, may be partly an attempt to correct the mistakes made in the conglomerate merger boom of the 1960s.

Financial Innovations and Mergers

Gregg Jarrell, formerly chief economist of the Securities and Exchange Commission, provided a financial economist's view of the role that financial innovations have played in the recent increase in merger activity. Jarrell attributes the rise in merger and acquisition activity to a combination of economic trends, changes in industry regulation and antitrust enforcement, and financial innovations. Of the financial innovations, Jarrell considers the growing importance of institutional investors to be the most fundamental. Highly sophisticated analysts now control large pools of mobile capital. As a consequence, managers are subjected to more intense scrutiny by the capital markets and funds are transferred rapidly to prospective acquirers who promise more productive management strategies.

Junk bonds, or bonds below investment grade, are another major innovation. In diversified portfolios, junk bonds have historically provided high returns and small losses. These high returns have attracted investors, such as thrift institutions and pension funds, that previously avoided securities below investment grade. For borrowers, junk bonds are attractive because they do not have many covenants and, thus, impose fewer restrictions on the borrower than investment-grade bonds or bank financing. For smaller borrowers, junk bonds may also be the only available source of non-equity capital. Associated in the public eye with hostile takeovers, junk bonds have also become important for friendly acquisitions and financial restructurings. They have contributed to the growth in leveraged buyouts, as the high debt burden of such companies makes financial flexibility vital.

Jarrell also reviewed the relationship between antitakeover regulations and corporate defenses, on the one hand, and financial innovations and takeover offensive tactics, on the other. Restrictions on hostile takeovers are typically justified on the grounds that they protect the shareholders of the target company. However, Jarrell has found no empirical support for the view that target shareholders suffer in a takeover. On the contrary, the target's stock price rises substantially in a takeover attempt. If the restrictions lead to an auction, with several bidders competing to acquire the target, the target price may be higher than otherwise; but if a takeover is thwarted entirely, the share price typically falls back to its original level. Jarrell expects antitakeover laws to grow in popularity. While this will make takeovers more costly and time-consuming, Jarrell also expects that new financial innovations and takeover techniques will be developed to circumvent these barriers.

Discussion: Interest Rates and Stock Prices

The discussion centered on whether the merger wave could survive

an economic downturn. Acquisition specialist Frank Haydu, in contrast to Ravenscraft, argued that macroeconomic conditions, specifically the decline in interest rates and the rise in stock prices, have helped foster the merger wave. Haydu, who has organized many leveraged buyouts, stressed the importance to investors of being able to recycle funds. Investors who take firms private with a leveraged buyout hope to profit by reselling the firm to the public. How many leveraged buyouts would be viable if the firms could not be sold back to the public after they had been turned around? If the economy were to turn down and the stock market were to decline, many highly leveraged acquisitions would have trouble making debt payments and their owners would incur substantial losses if they tried to sell. Jarrell agreed that recent financial innovations have yet to be tested by a recession, but he emphasized that the junk bonds used to finance many leveraged buyouts have considerable flexibility, so troubled firms can restructure their financing rather than enter into bankruptcy.

Changing Valuation Techniques

Batterymarch fund managers Dean LeBaron and Lawrence Speidell demonstrated how new valuation techniques have enabled institutional investors to identify undervalued firms. Their approach, which uses publicly available data, challenges key premises of the financial economists, who typically argue that the stock market prices firms efficiently, so that the stock price reflects the firm's underlying value based on publicly available information.

According to LeBaron and Speidell, stock prices in the 1950s and 1960s were set by individual investors relying on research analysts, while prices in the 1970s were determined by institutional investors looking at accounting ratios for the corporation as a whole. In the 1980s, however, LeBaron and Speidell believe that valuations are beginning to be based on the replacement cost of corporations' underlying assets. A few "corporate raiders" were among the first to observe that the replacement value of a firm's assets may exceed the value placed on the firm as a whole by the stock market; the raiders exploited these discrepancies between replacement and market values, financing takeovers of such companies by selling off the assets. Increasingly, however, current management is noticing differences between replacement and market values and is taking steps to increase the market values and close the gaps. These steps include spinning divisions off as separate companies, repurchasing shares in the company, and revealing more information to investors about undervalued assets. LeBaron and Speidell expect this trend to continue; accordingly, they have developed a technique for identifying firms with low ratios of market to replacement values, anticipating that

these firms will either be restructured by current management or be taken over. In either case, the market value will increase and early investors will profit.

The authors show how their "chop shop" technique can be applied using business segment data. Basically, the market values of diversified companies are compared with the values of single-line-of-business companies corresponding to the conglomerates' subsidiaries. In general, diversified companies seem to have market values below the sums of the market values of their appropriately weighted "parts." By way of explanation, LeBaron and Speidell observe that closed-end funds, that is, mutual funds with a fixed portfolio and limited shares, frequently sell at a discount from the market value of the portfolio. Similarly, firms for which it is difficult to disentangle the values of subsidiaries may be penalized. LeBaron counseled that the manager who wants to fend off takeover attempts should simplify his operations and provide full information on undervalued assets.

Discussion: Feasibility

Joseph Grundfest of the Securities and Exchange Commission doubted the feasibility of evaluating firms by their replacement values. Grundfest believes that valuing firms using information on subsidiaries poses serious methodological difficulties. The accounting problems are daunting. For example, different firms use different approaches in allocating revenues and costs among their various subsidiaries. The industry definitions upon which the line-of-business data are based are broad, so that very different companies will be classified in the same industry. Grundfest also questioned how the replacement value approach captures the value of intangibles, such as brand names, or takes into account unique land holdings. He suggested that the appropriate question was not why the parts are worth more than the sum, but why some corporate structures had proved more successful than others. Grundfest agrees with the view that many of today's bust-up takeovers and divestitures are reactions to past merger mistakes.

In summary, a more competitive environment in deregulated industries, more liberal antitrust enforcement, the pressures of international competition, changes in investor attitudes and valuation approaches, and greater access to takeover financing all played a part in causing the current merger wave. Financial economists emphasized the pressures for restructuring, financial innovations, and improved valuation techniques. Industrial organization specialists stressed changes in antitrust enforcement and deregulation, unrealistic expectations of efficiency gains, and the correction of mistakes from earlier conglomerate mergers.

All agreed that no one factor could adequately explain the merger boom.

Effects of Mergers and Acquisitions

In assessing the effects of mergers and acquisitions, both financial and industrial organization economists agreed that shareholders in target companies enjoy substantial gains, as the stock price of a target typically rises when an acquisition attempt is announced. They differed, however, in their interpretations of the increase in stock prices.

Free Cash Flow

Michael Jensen of Harvard and the University of Rochester provided the perspective of the financial economists. The appreciation of the target's stock price reflects efficiencies arising from the acquisition. Gains to target shareholders are not offset by losses to other parties. Bidder company shareholders do not lose, on balance, and while target company employees sometimes suffer wage cuts and employment losses, Jensen attributes these to the competitive pressures giving rise to takeovers rather than to the takeovers themselves. Efficiency gains may be due to synergies between the target and the acquiring company or to the replacement of inefficient target management.

Resolving conflicts between managers and shareholders over the disposition of free cash flow is one way in which takeovers lead to a more efficient use of corporate resources. Jensen defines free cash flow as cash flow in excess of the funds necessary to undertake projects with positive net present values. Free cash flow develops when a company has limited growth potential. The oil and gas industry provides an extreme example: price increases in the second half of the 1970s created large profits but curtailed consumption, creating excess capacity. An efficient allocation of resources requires that free cash flow be paid out to shareholders. Managers, however, are encouraged to retain this cash and overinvest in internal projects, because compensation and job security are often tied to company size and sales growth. Also, by retaining free cash flow, managers avoid the scrutiny of the external capital markets should a need for investment capital arise.

Companies with free cash flow are attractive takeover targets, as the acquirer can use the target's free cash flow to finance the takeover. The target's debt is increased, based on the expected stream of free cash, and the proceeds are used to pay the takeover premium to the target shareholders. In addition, the resulting increase in leverage requires that the acquiring management operate the firm efficiently and removes managerial control over future free cash. Incumbent management can

achieve the same result by issuing debt in order to buy back stock or by arranging a leveraged buyout.

Companies with free cash flow may also be acquirers as well as acquisition targets. Managers may embark upon acquisition attempts as a means of disposing of free cash flow. While it would be more efficient if the free cash flow were paid out to shareholders, these acquisitions may be less wasteful than investing in unprofitable internal projects.

Jensen expressed concern about the growing number of state laws restricting hostile takeovers. He attributed these restrictions to the lobbying efforts of executives of large companies, who find that size no longer protects them from takeovers. Although hostile takeovers account for a small fraction of all acquisitions, many apparently voluntary acquisitions would not occur without the implicit threat of a takeover. Accordingly, Jensen fears that these restrictions will discourage acquisitions generally and lead to a significant reduction in efficiency.

Discussion: Inconsistencies of Free Cash Flow Model

Edward Frydl of the Federal Reserve Bank of New York questioned the adequacy of the cash flow model as an explanation for mergers. In particular, the free cash flow explanation does not seem consistent with merger waves: declining industries with excess cash existed before 1980 as well as after. Also, the free cash flow model requires that managers behave inconsistently in that they put their own interests ahead of shareholders' in retaining cash flow, but in so doing they attract takeover attempts, which are not in their interest. Frydl expressed concern that competition among commercial banks and investment banks to finance risky leveraged buyouts might adversely affect the integrity of the deposit base. He also warned that ready access to financing could lead acquiring managements to take advantage of inside information to the detriment of shareholders.

Leveraged Buyouts and Management-Shareholder Conflicts

In the ensuing general discussion, several participants voiced concerns about the potential for management-shareholder conflicts in leveraged buyout transactions. Leveraged buyouts frequently are organized by incumbent management, who receive equity in the new organization. If the managers, as owners, can achieve efficiencies that enable them to pay a takeover premium, why were they not already achieving these same efficiencies? A conflict of interest exists, in that the takeover price will be lower if management runs the division or company poorly. Also, managers who are planning a leveraged buyout are unlikely to search for alternative higher bidders. Thus, incumbent management

may gain at the stockholders' expense. One advantage of leveraged buyouts is that, since top management frequently has equity in the new company, the incentive to operate the firm efficiently is very strong; a similar financial incentive could be created in firms in which management does not have an equity stake by tying management compensation to stock price performance.

Disappointing Postmerger Performance

Richard Caves of Harvard University challenged the financial economists' view that mergers and acquisitions result in more efficient performance, in the process clarifying the distinctions between the industrial organization and finance perspectives. Acquisitions are unlikely to have a favorable effect on the economy as a whole unless they are productive for the firms directly involved, and Caves finds little evidence that acquisitions are, in fact, productive for the combining firms. Although target company shareholders clearly gain in acquisitions, bidding company shareholders just break even on average; and since the bidding company is usually much larger than the target, Caves questioned whether shareholders experience significant gains overall.

Mergers have the theoretical potential to bring about efficiencies, for example through the sharing of lumpy multi-use assets or the replacement of inefficient management. However, a review of the industrial organization literature on postmerger performance indicates that acquiring firms do not experience increases in profitability or productivity and that the market shares and profitability of acquired units decline. Studies of British mergers suggest that transition costs wipe out potential gains. Caves, in recent work with David Barton, found a negative relationship between technical efficiency and the extent of corporate diversification. Caves attributes this result to the difficulties of managing disparate lines of business. He sees this as supporting the argument that acquisitions, at least diversifying acquisitions, are unproductive.

Given the conflicting evidence of large gains to target company shareholders, on the one hand, and disappointing postmerger performance, on the other, Caves called for more research into the motivations of acquiring managements. While conflicts between the management and shareholders of target companies have received considerable public attention in proposals to restrict golden parachutes and in the general debate over state antitakeover laws, the conflicts between the management and shareholders of acquiring companies have been, in comparison, ignored. The large gains to target shareholders may mean simply that acquiring managements pay too much. Jensen's theory of free cash flow applies to acquirers as well as targets, implying that cash-rich companies are likely to engage in unproductive acquisitions. Caves suggest-

ed that tax policies could be designed to encourage management to pay out free cash flow to their shareholders. Despite his negative view of mergers, Caves observed in his presentation that he does not favor anti-takeover laws and other measures that would protect incumbent management from displacement.

Discussion: Future Research

In response to Caves's questioning whether the combined appreciation in target and bidder market values is positive, Michael Bradley, a financial economist, cited recent work by Desai, Kim, and Bradley showing a statistically significant positive gain overall. Both the target shareholders' share of the total and the dollar value of the overall gain have increased over time. Bradley urged combining the research approaches of the financial and industrial organization economists to determine the sources of these gains. Does the stock market, in responding to acquisition announcements, accurately distinguish between successful and unsuccessful post-acquisition performance? Bradley cautioned, however, that the postmerger performance of the acquiring firm cannot be the only standard by which an acquisition's success is measured; one must also take into account the gains to target shareholders.

Bradley agreed that bidder motivations are a subject worthy of study but doubted that overoptimism or hubris could be a general explanation for mergers, as shareholders can prevent such unproductive empire-building by enacting charter amendments restricting acquisitions or by changing management compensation practices. Changing management compensation practices would help resolve management-shareholder conflicts in both bidders and targets: if compensation were related to a firm's market value, management would be less inclined to engage in unproductive acquisitions or to oppose takeover offers that carried large premiums over the current stock price.

Implications for Public Policy

The final two papers considered some of the public policy implications of the merger boom. William James Adams of the University of Michigan focused on the implications for competition, a traditional concern of industrial organization economists.

Mergers and Competition

Less restrictive antitrust enforcement was generally seen as one of the more important factors contributing to the merger boom. Adams

took issue with key premises underlying this liberalization. Specifically, he disagrees with the view, associated with Robert Bork, that anti-competitive results arise only from horizontal mergers and then only from mergers in markets with high degrees of concentration. Adams contends that horizontal mergers can lead to increased market power and higher prices even in relatively unconcentrated markets. As evidence, he cited a recent study of the airline industry indicating that increases in market share are associated with higher fares; the effect on fares is most pronounced when market share is low. Adams attributed this result to barriers to new competition not captured by the concentration statistics, for example frequent flyer programs and computerized reservation systems that tie passengers to carriers serving multiple locations. Because of these barriers to entry, mergers in the airline industry could lead to higher prices, even though the resulting market shares would not violate antitrust guidelines. Adams concludes that concentration, alone, is a poor proxy for market power; antitrust policy should take into account the barriers to entry and other sources of market power in the individual markets and industries in which mergers occur.

Vertical and conglomerate mergers should also be subject to closer scrutiny, according to Adams. Although vertical and conglomerate mergers do not result in higher levels of concentration in a market, they may have anti-competitive effects. In particular, when firms compete in a number of different markets, the frequency of contacts and resulting familiarity facilitate collusion and may discourage aggressive competition. A cooperative pricing strategy developed in one market may be applied in other markets where the same firms compete. More generally, information about the behavior of competitors gained from contacts in other markets may enable an oligopolistic firm to predict more accurately how these rivals will react and thus may facilitate cooperative pricing. Vertical and conglomerate mergers may increase the number of points of contact among firms and, therefore, the opportunities for collusion.

Adams believes that an examination of European merger policy, particularly as regards joint ventures and mergers of failing firms, would be very informative. While the case-by-case approach of some European countries has proved cumbersome, lessons from the European experience may assist in "fine-tuning" U.S. antitrust policy.

Discussion: Current Antitrust Environment

In response, Robert Crandall of The Brookings Institution argued that the current economic environment does not support a more restrictive antitrust policy. Neither the merger wave of the 1960s nor the current merger wave has increased concentration. Even in industries in which mergers have reduced the number of U.S. competitors, competi-

tion from overseas producers has prevented U.S. firms from exercising market power. Moreover, the correlation between concentration and profits is far from clear-cut. Crandall conceded that there is some evidence that firms competing in multiple markets are not as aggressive competitors as firms competing in single markets, but the evidence is not sufficient to warrant a change in antitrust policies.

Restricting Hostile Takeovers

The regulatory response to the current merger wave has focused on restricting the small fraction of acquisitions that are hostile tender offers. Lynn Browne and Eric Rosengren of the Federal Reserve Bank of Boston considered whether regulation should treat acquisition attempts that are opposed by target management differently from those that have management's support. Confirming the observations of earlier paper-givers, they found that target company shareholders fare as well in hostile takeovers as in other acquisitions. Indeed, stock prices rise somewhat more in response to the announcement of a hostile tender offer than to the announcement of a merger or an attempt to take the company private. Thus, if the welfare of target company shareholders is the primary concern of regulators, the emphasis on hostile tender offers is misplaced.

Browne and Rosengren also examined the performance of hostile takeover targets along a number of dimensions. One might expect hostile takeover targets to be relatively inefficient in terms of their profitability or capital structures, since acquisitions in which the motivation is the replacement of inefficient management would presumably engender more opposition than acquisitions based on synergies between target and bidder. However, Browne and Rosengren found that targets of hostile takeovers are not very different from targets of friendlier acquisition proposals and probably not very different from companies generally. Thus, if the replacement of ineffective management is the motivation for hostile takeovers, the nature of the management failure is not obvious. Such a result casts doubt on the argument that takeovers promote efficiency by exerting a useful discipline on managers in general. At the same time, the similarity between takeover targets and other firms provides no basis for protecting takeover targets and their managements from changes in control.

Discussion: Changing Managerial Incentives

John Coffee of the Columbia University Law School expanded upon the theme running through both the Browne and Rosengren paper and the conference as a whole—target shareholders gain from acquisitions but the sources of these gains are unclear. Coffee suggested several pos-

sible sources of the gains to shareholders, including transfers from managers, employees, and other "stakeholders" in the target corporation, as well as efficiency gains from restructuring diversified corporations and curtailing managerial empire-building.

Regardless of their source, if shareholders were to share their gains with target management, they could secure management's acquiescence to takeovers. Without such a sharing of takeover gains, Coffee expects state antitakeover laws and corporate defense tactics to prove substantial impediments to takeovers. A number of conference participants objected to Coffee's specific proposal that senior management receive a percentage of the takeover premium paid to shareholders, arguing that this would create perverse incentives. However, they supported the objective of changing management compensation practices so as to reduce conflicts between management and shareholders.

Conclusions

The conference brought together representatives of the finance and industrial organization fields to explore the causes and implications of the current merger boom. Financial economists found substantial benefits in the current increase in acquisition activity, which was seen as part of a major restructuring of U.S. business. Competitive pressures are forcing U.S. corporations to become more efficient. In response to these pressures, firms are changing their internal operations. They are also divesting themselves of divisions that do not fit their current business strategies and they are acquiring firms that will enhance their competitiveness and that they can operate more efficiently than present management. Evidence of the benefits from mergers and acquisitions is found in the large increases in the stock prices of target companies when acquisition proposals are announced. Those holding this view strongly oppose attempts to restrict hostile takeovers.

Most industrial organization economists took a much dimmer view of mergers and acquisitions. Looking at postmerger sales and profit performance they concluded that most mergers are unsuccessful. The increase in mergers and acquisitions, according to this view, reflects excessive optimism and empire-building on the part of acquiring managements, the breaking up of unsuccessful conglomerates formed in previous merger booms, and attempts to take advantage of more liberalized antitrust enforcement. Although some concern was expressed about the negative consequences of mergers for consumer welfare, the industrial organization economists, while skeptical of the benefits from mergers and acquisitions, were reluctant to restrict takeovers.

Even though attitudes towards mergers and acquisitions differed

substantially, there was agreement in several areas. The suggestion that the research methodologies of financial economists be combined with those of industrial organization specialists was favorably received. By comparing the stock market's response to acquisitions, as shown by event studies, with postmerger accounting and market structure results, it may be possible to reconcile the existence of large shareholder gains with disappointing postmerger performance.

Management compensation packages were seen as a fruitful area of study, with changes in management incentives having the potential for resolving management-shareholder conflicts. Such conflicts may arise both in takeover targets and in acquiring firms. It was suggested that tax policy be altered to encourage the adoption of management compensation packages based on stock performance.

The conferees also agreed that the regulatory response to the current merger wave, state laws that limit hostile takeovers but do not affect acquisitions supported by target management, is misguided. Restrictions on hostile takeovers will not eliminate the disruptions to employees and communities or the increases in market power that sometimes result from mergers, while they may preclude acquisitions that would revitalize management and lead to productivity gains. Such restrictions certainly do not achieve their stated purpose of protecting target company shareholders. Both industrial organization and financial economists agreed that the shareholders of target companies benefit in takeover attempts, sometimes more in an unfriendly takeover than in friendly mergers or management buyouts. What the conferees did not resolve is whether mergers and acquisitions benefit the economy as a whole.