TAKEOVERS - WHO WINS?
RESEARCH POINTS TO BENEFITS

by LINDA ENGLISH

Vigorous debate continues over whether corporate takeovers help or hinder the functioning of the financial community. Opponents claim takeovers merely move shares about, damage some shareholders and threaten competition. Another view, based on a study of 1,400 Australian companies, is that takeover activity actually creates value.

In the past few months the public outcry against takeovers, and accompanying demands for legislative change to restrict or even prohibit them, have abated. At the time of the Centre for Independent Studies conference on takeovers (June 1986) there was a hue and cry against the proposed Bell takeover of BHP. While that situation has temporarily resolved itself and the passion of the debate eased, much of the changed public attitude towards takeovers must be attributed to the work of Professors Dodd and Officer.

The pressure unwarranted takeovers offers places on target management resulted in strident calls for the regulation of takeovers. This call had not gone unheeded. In the past decade there has been an unparalleled growth in regulations governing takeovers. The debates that have accompanied these legislative initiatives have generated a longlist of war stories, myths and folklore about the pros and cons of takeovers. The myths have arisen as the pro and anti-takeover lobbies defend their stances with case examples and simplistic armchair economics. The public policy deliberations have been characterised by a lack of comprehensive analysis. Anecdotal evidence has held sway as the legislation has mushroomed.

The sections of companies and securities legislation that relate to takeovers grew from approximately three pages in 1961 to more than 150 pages by 1981.

Recent research by Professors Peter Dodd and R.R. Officer on the effect of takeovers on the economy has been very influential in the wider community, stemming the unquestioning and often insufficiently justified tide of government regulation of the securities industries.

The research was somewhat unusual in that it was commissioned by an external party. The Centre for Independent Studies proposed the research in 1984, sponsored international conferences in Australia and New Zealand in 1986 and subsequently published the results of the Dodd and Officer research and the conference proceedings. A major objective of the study was to develop a comprehensive database of takeovers in Australia. Such a database is a prerequisite for research on the economic consequences of takeovers, which in turn can be utilised in policy deliberations.

The research so far published is:


Professor Officer is at Melbourne University’s Graduate School of Management (GSM). Professor Dodd and Steven Bishop represent the University of NSW’s Australian Graduate School of Management (AGSM).

Since the completion of the research Professor Dodd has left the AGSM to join the investment bank Whitlam Turnbull.

Linda English is a tutor in the School of Accounting, University of New South Wales. This is adapted from an article published in the journal Australian Accountant.
The National Companies and Securities Commission also appeared to appreciate the need to base regulatory policy on empirical evidence. In 1985 the NCSC and the Victorian Division of the Australian Institute of Management (AIM) commissioned Professor E. McDougall and David Round to undertake a study into the determinants and effects of corporate takeovers in Australia.

At the CIS conference in June 1986 the conflicting results of two studies into the Australian evidence on takeovers were presented. The timing of the conference, together with publicity surrounding it, and the publication of the research and conference proceedings, has helped to promote Dodd and Officer’s work. But publicity, timing and topicality are not sufficient to guarantee that research will be noticed, let alone that it will colour the debate outside academic circles. What is it about the Dodd and Officer research that has made it so influential?

The breadth and quality of the research is paramount. Before the completion of the empirical study Dodd and Officer considered the role takeovers play in the context of economic and finance theory. In doing so they gently exposed many of the anecdotal arguments used to promote the regulation of takeovers.

The presentation of their work at the CIS conference introduced it to a wide audience and gave it added credibility. It became apparent that what they were saying was collaborated by academic colleagues in Australia, New Zealand and the US.

The general consensus at the conference confirmed the suitability of the Dodd and Officer research methodology (and hence the validity of their conclusions) over the methodology employed in the study commissioned jointly by NCSC and AIM.

Finally, the publication of the results of the empirical study confirmed the conclusions of their theoretical analysis.

Dodd and Officer have taken pains to make their analysis accessible to the non-academic. Without in any way diluting the logic of their theoretical argument or oversimplifying the reader’s introduction to a complicated methodology, they manage to communicate their ideas persuasively.

Cutting through the noise generated by the debate on takeovers, Dodd and Officer identified one central issue; it was whether takeovers, as corporate investments, create value and enhance resource allocation.

Dodd and Officer reason that the implications of economic theory are that these transactions are value-increasing.

The importance of sound analysis, with particular attention to the collection of evidence on the effects of takeovers, is a theme found in the published views of all the major speakers at the CIS conference.

Too often, new regulations over securities markets and other aspects of business have been promulgated with little attention to whether or not reliable evidence is available to support the perceived ills that the regulation is aimed at fixing. Regulation of partial takeovers in Australia is an obvious example of evidence ignored.

Dodd and Officer noted that competition was to be expected in the research market. Different studies using different research methodologies can produce inconsistent results.

This was the case with the Australian evidence on takeovers presented at the conference. McDougall and Round used a sample size of 88 firms and a methodology based on a complex analysis of the major corporate performance characteristics in pre and post-takeover periods. These performance characteristics were largely based on accounting data and incorporated measures of profitability, risk, leverage and growth.

By contrast, all other evidence reported at the conference used a methodology based on capital market rates of return after adjusting for capital changes such as bonus issues and adding back cash distributions such as dividends. The problem of finding a suitable control was solved by compiling separate portfolios of target and bidding firms and then comparing the performance of these portfolios with another portfolio that incorporated the market for all equities. Use of this methodology enabled Dodd and Officer to examine the effects of takeover offers on more than 1,400 firms over a period of 13½ years.

The notion behind this control is that all the other factors that affect share prices, such as the state of the economy, government policy etc., will be captured in the market portfolio. Therefore, the only distinguishing feature between the market (control) portfolio and the portfolio of acquiring or target companies will be takeover activity.

What causes the change in expected
income (benefits) and therefore a change in value of a target’s share price on or before the announcement of a takeover offer? The price that the acquiring company is willing to pay for the target indicates the present value of the minimum return that company expects to accrue as a result of the investment in the target.

The subsequent price adjustment made to both the acquiring and target company shares reflects the market’s evaluation of the effect on future income streams of both entities that are likely to result from the takeover.

One of the factors that undoubtedly makes sceptics suspicious of the link between real values and share prices is the large variability in those prices. The problem is not that share prices fluctuate, but with the belief that a company has a relatively constant real value.

Even if balance sheets were prepared on a daily basis they would not reflect real asset values and cannot be taken to represent the market value of companies. Use of an historical-cost based valuation system with its attendant measurement rules is one obvious reason. Another is that the sum of individual assets (no matter how valued) does not necessarily reflect the market value of the company as a whole. This is because market value is determined by how profitable the assets are when combined together as a firm under a given management.

Many criticisms of stock prices as measures of company value involve notions either of irrational behaviour on the part of investors or of misleading information investors cannot detect.

Many criticisms of stock prices as measures of company value involve notions either of irrational behaviour on the part of investors or of misleading information investors cannot detect. This does not mean in the long term securities prices are biased or unrelated to real asset values. Prices are set at the margin. The issue really is whether there are sufficient investors who are rational and willing to invest in evaluating information to ensure prices are not driven by irrationality or misleading information.

Much of the debate on stock prices and real values revolves around the nature of information used by market participants when setting prices. Accounting data are a primary source of information on company performance, yet traditional accounting procedures do not provide numbers that are market values of firms.

There is overwhelming evidence that stock prices are, on average, set rationally and that the competition for information on company values is fierce. This evidence shows that changes the stock prices are related to reported earnings figures. Results indicate that the stock market anticipates much of the earnings-based information before the public release of the annual or interim reports. It is clear that the market uses more than reported accounting numbers when valuing companies.

Moreover, there is evidence that the market is not fooled by cosmetic changes in reported earnings that result solely from accounting procedures and not from real changes in a firm’s underlying economic performance.

Bishop, Dodd and Officer end their analysis with one final observation. They put the onus on those who believe that share prices do not reflect economic values to explain what in fact stock prices are based on. Why, they ask, do corporate managers continue to act as though their firm’s performance is reflected in share prices? Why are annual changes in stock prices strongly correlated with the subsequent announced earnings of companies? Why do analysts and professional investors spend huge sums trying to forecast these earnings accurately and trade on their expectations? Why do legions of investors continue to invest in professionally-managed funds, and why do government and others look to share markets as the leading indicator of the economy?

While some may not fully understand the relationship between share prices and asset values, it could be that the argument which claims takeovers are merely exercises in paper-shuffling cloaks a moral objection to the ways in which target shareholders choose to spend their liquidated assets, or even to the fact they are entitled to the profits at all.

Many target shareholders will accept share-swaps, choosing to reinvest in the acquiring company. Of those who receive cash some will reinvest in alternative opportunities. Others will put their money into “non-productive” assets such as new houses and cars.

It could be argued that even the latter type of “non-productive” investment brings real benefits to the economy indirectly in that such purchases stimulate the production of goods and services.

However, if the real objection is to the spending habits of target company shareholders, regulation of takeovers is not the appropriate way to encourage a preferred pattern of investment or consumption. Alteration of tax laws would be more appropriate.

Between January 1972 and June 1985 the total value created by takeover offers, as measured by the change in residual values of the outstanding shares of the firms involved, is estimated at $7.2 billion. This amount excludes gains due to market-wide phenomena and was shared by shareholders of target and bidder companies.

The evidence on takeovers in Australia is that they are, on average, value-creating transactions. It is also clear that takeovers do not benefit one group of shareholders at the direct cost of another.

The more contentious findings relate to the shares of acquiring firms. On average, it appears that these shares are not revalued upwards to anywhere near the same extent as the shares for acquired companies, and in many instances the market believes that acquiring firms have paid too high a price for the acquisition.

The question is whether these lower returns to acquiring company shareholders, which in some instances appear to result in losses, imply the need for regulations restricting takeovers. Is the
The question is whether these lower returns to acquiring company shareholders, which in some instances appear to result in losses, imply the need for regulations restricting takeovers.

The sheer magnitude of the financial commitment, and the strategic significance of takeovers, focus the investment community’s attention on the management of the firms involved.

The market for corporate control provides the mechanism by which company assets can be channelled to those who are most efficient in using them.

A change in corporate control through a takeover is not the only mechanism by which resources are allocated more efficiently within the economy. Dodd and Officer argue that takeovers represent an alternative investment strategy to internal expansion.Choice of strategy will depend on which course of action is estimated to result in higher net returns, maximising shareholders’ wealth.

Takeovers, however, tend to attract more attention than other strategic investment decisions. The sheer magnitude of the financial commitment, and the strategic significance of takeovers, focus the investment community’s attention on the management of the firms involved.

No single investment decision is more fully disclosed to and discussed by the market. Attention is applied equally to the target company and the standard presumption of those monitoring the events is that the acquiring company has discovered a better strategy for utilising the target’s existing asset base.

Despite the feelings of insecurity the threat of a takeover often brings out in target management, it would be a mistake to assume that the justification or reason for most takeovers is that the incumbent management is not acting in the interests of shareholders.

However, takeovers can control the self-interest of those managers who would prefer to pursue private goals at the expense of their shareholders. The existence of an active market for control of corporations belies the belief of those who claim management acts independently and against the interests of shareholders.

A market for corporate control thus has two major functions. It contributes to the general economic well-being by providing the opportunity for firms to combine to form more efficient and profitable entities. It also provides a self-regulatory monitoring mechanism...
which ensures that the interests of management cannot diverge too far from those of its shareholders.

The liquidity of capital markets, combined with the opportunity to earn abnormal returns, attracts investors to stock markets. As investors are both directly and indirectly the principal source for the transfer of savings to securities markets, the inducement of high returns brings a benefit to society in the form of increased investment opportunities.

Increased prices in the secondary markets (as a result of takeovers or alternative investment strategies) enable companies to raise funds in the primary market on the most advantageous terms. This in turn stimulates further investment.

The overriding implication of the economic theory of takeovers is that they are value-increasing. The results of Bishop, Dodd and Officer's research confirm that the economy benefits from takeover activity.

The onus is now on those calling for the regulation of takeovers to disprove the case put forward by Dodd and Officer. At the moment the anti-takeover lobby is unusually quiet. When the call for regulation is next heard we have to ensure that it is properly backed by research before we permit legislative change.

**CURBING THE MARKET-MAKERS**

Stricter regulation of professional advisers, as a means of controlling the conduct of takeovers in Australia, is advocated in a submission by the merchant bank First National Limited to the Federal Attorney-General, Mr Bowen.

Under the First National approach, professional takeover advisers such as merchant banks and stockbrokers would be registered with the National Companies and Securities Commission.

It would become mandatory for companies involved in takeovers, or in transactions that might lead to a change in corporate control, to appoint registered advisers. These advisers, in turn, would be answerable to the NCSC.

Advisers deemed to have been involved in a breach of the Takeover Code, or to have been guilty of unacceptable conduct, would be subject to deregistration, suspension or reclassification.

The First National submission also proposes the formation of a panel of leading businessmen, advisers, financiers, stockbrokers and NCSC representatives. To some extent modelled on the London Takeover Panel, the proposed panel would advise the NCSC in the development of policy and would hear appeals by advisers against the disciplinary decisions of the NCSC.

Mr Richard McKinnon, First National's chief manager, mergers and acquisitions, said the proposal recognises that the market is essentially driven by self-interest. "At present, it is the interest of advisers to push their clients to the limit of legal tolerance in order to meet client objectives," Mr McKinnon said.

"The present situation positively discourages advisers from complying with the spirit and intent of the law. They are rewarded for their ability to bend the law and to find loopholes in the Takeover Code."

"One unfortunate result in this practice has been to generate a great deal of expensive, time-consuming litigation, and to cast the NCSC in an adversary role instrumental in determining the conduct of takeovers. However, it is the companies involved, not their advisers, who are usually subject to penalties or loss of reputation when irregularities are found.

"Our proposals would produce the opposite effect because advisers would know their livelihoods were at risk if they failed to induce their clients to abide by the spirit and intent of the Takeover Code.

"Companies intent on breaching the code, or otherwise stretching the law, might even find it impossible to acquire

**The present system positively discourages advisers from complying with the spirit and intent of the law. They are rewarded for their ability to bend the law...**

rather than as a facilitator of the fair and efficient working of the market."

Mr McKinnon said that if there is to be effective regulation of takeovers in Australia, then those who transgress the Takeover Code should be subject to stiff penalties. These penalties should be directed at the real market-makers.

"First National believes that the market-makers are not so much the primary participants — the offerer and offeree companies — but the professional advisers.

"The attitude of advisers is often the services of a registered adviser, and thus be unable to proceed with the takeover transaction."

Mr McKinnon added that while the First National proposal represents a major shift in emphasis, it should not require significant legislative change. The NCSC would remain, as would the existing Takeover Code.

The proposal could also be introduced under either the present Co-operative Scheme, or the proposed "national scheme."