

Should Corporations Flush With Cash Use It for M&A? – M&A Track Record Raises Questions About This Strategy

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As the US economy plods through the “Great Recession”, corporations are recording solid, if not impressive, profits in the face of weak revenues. These profit gains have been achieved through efficiency improvements which all too often have meant fewer jobs. As of the end of the summer we have gained back three quarters of the GDP but only 7% of the jobs that were lost in the recession. The ironic result is that in this weak economy many companies are flush with cash and have to decide what to do with it. Excluding cash at financial institutions, such as deposits at banks, liquid assets at US corporations are as high as \$1.8 trillion. Total nonfinancial corporate assets have declined from their peak level in 2007 of almost \$29 trillion to \$26.4 trillion yet liquid assets are up from \$1.5 to \$1.8 trillion over this same period. The percentage of total assets that are being kept liquid by companies has risen from 4.7% in 2006 to 7% as of the middle of 2010. The rise in liquidity is a natural reaction to the riskiness of a weak economy and it typically brings with it pullbacks from growth strategies along with efforts to deleverage.

In the first half of 2010 corporate profits exceeded the first half total corporate profits from 2006 which was a peak year for corporate profitability in the US. Many companies are showing good results and this has been a source of liquidity. The question now is what do those companies do with their mounds of cash?

In light of the anemic returns equity holders have received since the subprime crisis, the obvious argument would be to give the money to shareholders in the form of higher dividends or stock repurchases. While this might be the “right thing” to do, it appears that many companies are now looking at M&A as a more attractive outlet for this cash. Examples of such activity can be seen in Intel’s recent \$7.7 billion deal to buy McAfee and its \$1.4 billion offer for Infineon’s Wireless Solutions Business. These bids followed Intel’s agreement to buy Texas Instruments’ cable modem product line for an undisclosed amount, which itself followed the 2009 purchase of mobile software maker Wind River Systems for \$884 million. Recently a wide range of bids has been put forth that range from a number of relatively smaller deals to the large \$39 billion mega-offer by BHP Billiton Canadian firm Potash Corp and the \$18.5 billion offer put forth by Sanofi-Aventis for Genzyme.

Consider the St Paul, Minnesota- based 3M which has made several recent acquisitions that are clearly tied to the company’s increasing liquidity. As 2005 ended the company had approximately \$1 billion in cash and \$7 billion in total current assets, but by the end of the second quarter of 2010 3M had accumulated over \$3 billion in cash and \$12.9 billion in total current assets. To 3M’s credit they were able to impressively expand their liquidity during a difficult economic climate. This industrial conglomerate that makes a wide range of products that range from health care supplies to its famous Post-it notes has made recently made a \$943 million offer Cogent - a finger print recognition business. Could there really be that many untapped synergies between finger print technologies and health care or Post-it notes?

Even very cyclical businesses are looking to get into the act. Normally cyclical companies struggle during recessions and weak recoveries. However, big machinery maker Caterpillar Inc.’s new CEO, Doug Oberhelman, has recently announced that their company has such a strong balance sheet that

he wants to use some of their liquidity for acquisitions. It is worth noting that which Caterpillar's cash holdings have quadrupled to \$4.9 billion in 2009 from \$1.1 billion in 2007. One would think that he would first wait to get his feet wet in his new CEO position instead of clamoring to spend shareholders' hard won cash. Clearly, this weak recovery is very different from the ones we have become accustomed to.

Management at bidding companies can make a very credible argument that today's weak equity values present attractive buying opportunities for bargain hunting acquirers. They can also try to assert that with the consumer on the sidelines during this anemic recovery, growth opportunities are few and far between, thus making M&A the most viable means of achieving growth.

In order to decide if this reasoning is correct it helps to consider the track record of corporate M&A. When we do so we discover that it is spotty at best. Research has shown that the returns to shareholders of acquiring companies who make cash offers are on average zero or negative. However, in markets like this one, targets may be reluctant to sell when the values of their companies are so low and they may be more inclined to resist bargain hunting bidders. Takeover resistance tends to cause bidders to raise offer prices which benefits target shareholders but comes at the expense of acquiring shareholders' returns. If targets are able to facilitate an auction for the company, it is more likely that bidders may overpay and be stuck with what is called the "winners curse." We have to wonder did the bidding contest between HP and its long time rival Dell for 3Par, which HP "won" with a final \$33 per share bid that far exceeded Dell's initial \$18 per share offer, award HP the winner's curse? The acquisition price is three times the market capitalization of the target! HP contends that this price is justified based upon its perceived growth prospects in the storage technology area. If this is the case, then why did the market fail to come close to pricing these prospects at the level HP measured them at. The obvious answer is synergy but the track record of such synergies being realized is spotty. It is much easier to realize cost-based synergies of combining similar businesses, such as Exxon and Mobil. It is more difficult to achieve revenue-enhancing synergies which is what HP is counting on. Talking about synergistic revenue enhancement and growth is much easier than actually achieving it. Such achievements often take years to come to pass and by then the CEO may have departed the scene with a lot of shareholders' money in his or her pocket.

Bidding contests and takeover resistance benefit target shareholders through higher premiums but raise the productivity expectations of the deal from the bidder's perspective. A case in point is Sanofi-Aventis' \$69 per share offer for Genzyme Corp which was rejected by Genzyme management last month. Sanofi has chosen to now become increasingly hostile by going the bear hug route to the board which carries with it the implication that it is prepared to initiate a full-fledged tender offer. Tender offers tend to raise takeover premiums. One of Genzyme's largest shareholder is Carl Icahn who was able to engineer a bidding contest for ImClone Systems that maximized shareholder gains and left the "winner", Eli Lilly, with a lot of work to do to derive a solid return on what it paid. In this current M&A atmosphere one would never guess that we are in a weak recovery and worrying about a double dip recession.

Another cause for concern is the underlying motives of acquiring managers and CEOs in particular. The intentions of acquisitive CEOs are too often highly questionable. Research shows that CEOs tend to be rewarded by their boards with increased compensation for completing deals. In addition,

CEOs of larger enterprises tend to be paid more, thus providing another financial incentive for CEOs to acquire companies and build empires. Directors and shareholders need to beware of the empire builders.

The Intel acquisitions are interesting as they mark an expansion of a very successful chip maker into other fields. Research also shows that CEOs of diversified companies earn 13% more than their undiversified counterparts even though the stock value of diversified companies reflects what is known as a “diversification discount.” In contrast, when companies become more focused and sell off units, such as prior diversifications, share values tend to rise. CEOs, however, may be reluctant to do this as these smaller, more focused businesses may provide them with lower personal compensation.

Far too often deals are motivated by hubris instead of sound strategic planning. This problem is reflected in a whole host of modern M&A mega-failures such as Daimler’s acquisition of Chrysler and Citigroup’s serial acquisitions that eventually resulted in an unmanageable financial conglomerate. Jean Meissner’s highly acquisitive and dangerously debt laden Vivendi reflects a similar abandonment of strategic planning in favor of sheer size. Even so, there are also many examples of questionable strategic planning that can be pointed to such as the second largest deal of all time and the biggest flop – AOL-Time Warner.

There is a very large body of research on the reasons for the successes and failures of mergers and acquisitions. There is also an abundant body of research on corporate governance as it relates to strategy and M&A. However, while such research is very relevant to M&A decision making, it is highly unlikely that most corporate directors are familiar with this collection of academic study on the subject.

At times like this, with so much of shareholders’ money trapped in corporate entities, boards need to be extra vigilant to make sure that it is allocated to its most productive uses. Too often boards are beholden to CEOs and fail to exercise sufficient oversight. Too often they allow the CEOs they are charged with supervising to engage in unprofitable empire building. With companies filled with readily available cash, directors need to make sure that there is a very convincing reason why this cash should not be turned over to shareholders in light of the losses so many of them have incurred in their shrunken portfolios and downsized 401Ks. Mergers and acquisitions in a weak market can present great opportunities for value conscious buyers. However, boards need to be extra vigilant to make sure that the deals they pursue further the corporation’s long term strategic goals as opposed to the CEO’s short term monetary and psychic interests.

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