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COVER STORY

Addicted to Acquisitions

In the bad old days in New York's Times Square, con men used to fleece tourists at three-card monte. The cops cleaned that up in the 1990s. But other, quite legal, fast-shuffle games thrived nearby on Wall Street during the merger boom.

The blur of deals can hide a multitude of sins. Constant changes make it hard for outsiders to follow what's going on in a company. Worse yet, there's a veritable cookbook of legal ways to play with the timing and accounting of a merger. Companies can slow the target's sales and not collect bills till the deal closes so they can mine a bonanza afterward. They can get an appraiser to undervalue inventory so that sales margins look healthier. They can restructure the target and treat the costs as a liability--not an expense that must be deducted immediately from earnings.

Understanding merger cuisine is important as investors reevaluate companies that became addicted to acquisition in the '90s. Tyco (TYC), AutoNation, U.S. Office Products, and AT&T (T) each bought more than 100 companies between June, 1995, and August, 2001. All have badly lagged their peers' returns.

Tyco International Ltd., under disgraced ex-CEO L. Dennis Kozlowski, was a big user of one the simplest recipes for obfuscating what the likely effect of a merger would be on a company's business: selective disclosure. Companies have only to report deals they judge to have a material impact on them. Each undisclosed addition boosts sales, but the growth seems to come from the business. Kozlowski made great use of this loophole. Thomson Financial counts 169 deals over the six-year period, but Tyco has admitted it did 700 between 1999 and 2001 that it never named. It recorded the costs, however.

The bull market made small acquisitions very appealing for companies with high price-earnings ratios. Merging with a company with a low p-e mathematically boosts per-share earnings, making the acquirer's stock look like a better buy. Trouble is, the next fiscal year they have to do another deal to keep that up. Using his high-priced stock, H. Wayne Huizenga, chairman of AutoNation, went on a shopping spree in the mid-'90s. He bought 114 companies worth more than $7 billion: car-rental agencies, dealerships, scrapyards. EPS soared, then plunged. As Wall Street became wary, the stock fell more than 70%. The

company says that it now does far fewer deals and pays cash.

Questions even arose briefly about General Electric Co. (GE) Under now-retired CEO Jack Welch, it had bought 534 companies in six years, according to Thomson, more than seven a month. In a Mar. 20 investor newsletter, William H. Gross, managing director of Pacific Investment Management Co., said GE bought scads of tiny companies with its pricey stock to boost its per-share earnings. GE shot back to say it usually pays in cash, not stock. (Thus financial alchemy played no role). That--and the fact that GE's return on capital rose as it bought, meaning the deals added shareholder value--restored some trust. But GE has lost the premium it had before the Enron scandal made investors leery of fancy accounting.

Serial acquirers' antics are a recurring problem of bull markets. When companies can't grow fast enough for investors, they often do deals. And some pull tricks. The good news is many companies can't play the deal game now, in part because their stock is too cheap. Companies have to make money the real way. See? There are good things about bear markets.

By David Henry in New York

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