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COVER STORY

Mergers: Why Most Big Deals Don't Pay Off

A *BusinessWeek* analysis shows that 61% of buyers destroyed shareholder wealth

The spring of 1998 was a fast and furious time for dealmakers. As stocks soared in one of the most exuberant phases of the decade's great bull market, multibillion-dollar mergers poured forth. Two and even three companies unveiled major deals in a single morning. At times, business in the ballrooms of New York's Waldorf-Astoria Hotel--a favorite spot for press conferences--was so brisk that as one CEO tangoed out, he risked colliding with the next one waltzing in.

These deals were solid undertakings--purchases of long-established companies with proven business models, tangible assets, and thousands of workers, unlike the ephemeral Internet affairs that came later. On Apr. 6, for example, Sanford I. "Sandy" Weill's Travelers Group announced a \$70 billion merger with the banking behemoth then known as Citicorp, a deal so bold that it required Congress to repeal Depression-era laws about bank mergers. The next day, insurer Conseco Inc. (CNC) announced it was paying \$7.1 billion and a huge 86% premium to buy mobile-home lender Green Tree Financial. The following Monday morning, Bank One Corp. (ONE) offered \$28.8 billion for First Chicago NBD, and NationsBank bid \$59.3 billion for BankAmerica Corp., as it was then called. Three weeks later, Germany's Daimler Benz snapped up Chrysler Corp. for \$38.6 billion.

But an exclusive new study by *BusinessWeek* shows that fully 17 out of the 21 "winners" in the heady merger spring of 1998 were a bust for investors who owned their shares. If CEOs had kept their checkbooks under lock and key and simply matched the stock market performance of their industry peers, shareholders would have been far better off. For example, in the year after the Green Tree bid, Conseco shares lost 47% of their value. That's bad enough, but Conseco's relative performance was even worse. Shares of insurers in the Standard & Poor's 500-stock index rose 8% in the same time, meaning that Conseco lagged behind its peers by 55 percentage points--and that was before its stock spiraled down to 10 cents amid a debt restructuring, now under way. Daimler shareholders didn't fare much better: Their total returns underperformed S&P's index of auto stocks by 30%. Travelers shareholders were among the few who were in the money after a year, garnering returns that were a slim 2% better than other insurers.

Similar patterns appeared across the 302 major mergers from July 1, 1995, to Aug. 31, 2001, covered by our study, designed with Mark L. Sirower, head of the mergers-and-acquisitions practice of Boston Consulting Group (BCG). We used data from Standard & Poor's (like *BusinessWeek*, part of The McGraw-Hill Companies) and deal tracker Mergerstat. There was plenty to dig into. The M&A bonanza during those six years shattered record after record. It was five times greater than any previous M&A boom in U.S. economic history: In the three busiest years, 1998 to 2000, deals totaled nearly \$4 trillion--more than in the preceding 30 years combined. And, of course, it included the biggest-ever merger: America Online Inc.'s \$166 billion, all-stock bid for Time Warner Inc. in January, 2000.

Why were shareholders left with such a hangover after the binge? Primarily because the bidders paid too much. They were afflicted by what economists call the "winners' curse": So eager were they to snare a deal that the premium they paid gobbled up the merger's whole potential economic gain from the get-go. Meanwhile, sellers laughed all the way to the bank: They were suddenly offered 36% more than their shares were worth a week earlier.

Managers sometimes bought a pig in a poke--not fully understanding what they were getting. Often, they envisioned grand synergies that proved illusory or unworkable. They underestimated the costs and logistical nightmares of consolidating the operations of companies with very different cultures. They overestimated cost savings and failed to keep key employees aboard, sales forces selling, and customers happy. "Some companies fail to recognize that integrating acquisitions well is both an art and a science," says Jack Levy, co-chairman of M&A at Goldman, Sachs & Co.

While many managers are inept at picking winning deals, investors aren't. They have an uncanny knack of assessing quickly and accurately what impact a merger will have on a company's future cash flows and, thus, the value of its stock. That's why we used the stock market returns of buyers one year after their bids to measure whether a merger was successful. Many CEOs disagree with assessments of their performance by investors, but the market remains the most reliable measure. And while a year may seem cruelly brief for judging a merger, research by Sirower, author of *The Synergy Trap*, and Stephen F. O'Byrne, president of Shareholder Value Advisors Inc., has shown that the way prices move shortly after an acquisition is announced is a very good predictor of the buyer's operating performance over the next five years. "Knowledgeable investors can understand the economics of a deal in a minute," says Sirower.

To ensure that they were significant economically to the company, we focused on deals worth at least \$500 million, eliminating any in which the buyer offered less than 15% of its market capitalization. The average buyer in our sample paid an amount equal to 47% of its own market value. We weeded out deals that were followed within a year by another significant acquisition by the same buyer. That's because it's nearly impossible to figure out the impact from one deal if another follows soon after. Besides, we suspected some companies were more interested in playing accounting games with serial acquisitions than in making deals likely to add real value to their businesses.

The main conclusions of our study:

-- Fully 61% of buyers destroyed their own shareholders' wealth. A year after their deals, the losers' average return was 25 percentage points below their industry peers'. The gains of the winning minority

couldn't make up for the buyers' losses: The average return for all buyers was 4.3% below their peers and 9.2% below the S&P 500.

-- The buyers lost largely because they paid too much, transferring wealth to the sellers' shareholders. From the week before the deals to the week after, sellers collected a hefty 19.3% extra return on their stock market value vs. their peers.

-- Bad deals don't get better on the whole if you wait longer to assess them. Among a 150-strong group of losing buyers whose purchases were not overshadowed by another deal in the second year, about four-fifths still showed negative returns after 24 months. About two-thirds of those showed no improvement at all.

-- Companies that paid for their acquisitions solely with stock--65% of the cases--showed the worst results. After a year, they lagged behind their peers by 8%. By contrast, those paying entirely cash gained 0.3%.

-- Investors' initial reactions were good predictors of subsequent price action. Of the bidders' stocks that traded down relative to their peers in the first week after their deals, 66% were still laggards a year later, by an average of 25%. The stocks that were up initially went on to score even bigger, turning a smallish 5.6% gain into a 31% leap a year later.

The worst deal of the lot by our reckoning was an Internet play. On Feb. 14, 2000, WebMD Corp., then known as Healtheon/WebMD ([HLTH](#)), announced a bid to buy Medical Manager Corp. and a subsidiary, CareInsite Inc., for \$3.2 billion in stock.

It was a veritable St. Valentine's Day Massacre. Forged at the peak of the Internet stock bubble, it burned shareholders of both seller and buyer. The 48% premium quickly evaporated. And, a year on, the company limped 152% behind its health-care peers as doctors and insurers balked at using WebMD's services. Roger C. Holstein, a member of WebMD's office of the president, says: "We were a health-care company with an Internet valuation. It makes for a difficult comparison."

By contrast, the no-nonsense purchase of office-supply company Corporate Express Inc. by Amsterdam-based business-supply giant Buhrmann ([BUH](#)) turned out to be a big winner. Everything about the deal was right. The Dutch company's \$1 billion bid was in cash, a sure sign of management's confidence in the acquisition. It paid a below-average premium of 24% for a company whose stock had been falling. And since Buhrmann already owned a major U.S. business in the field, BT Office Products International, the deal was a great consolidation play. The market liked the deal from the start, with Buhrmann's stock rising 20%. A year later it was up 110%, while rivals' stocks fell 19%.

Despite their patchy record, CEOs are still compulsive dealmakers. Indeed, after a brief lull, their appetites will likely quicken when they see prices of other companies falling faster than their own. This year, about 5,400 deals worth \$346 billion were announced through Sept. 30, according to Mergerstat. Even though that's way behind 1999's record \$1.4 trillion, it could match the 1996 score of \$470 billion.

Still, individual investors can draw some useful pointers from our study. Their best strategy is usually to sell as soon as they see a pair of CEOs approaching a podium. If they're lucky enough to own stock in the target company, they're likely to get the lion's share of the gains--within the first week. The buyer's shareholders do best three times out of five by selling. But if their stock rises in the first week, they might do better by holding on.

Our results come at a time when the public is demanding that corporate directors do a better job overseeing top management. They show that there has been no improvement in CEOs' dealmaking skills since 1995, when *BusinessWeek's* major survey of mergers in the early 1990s found that half were failures. Since then, an army of consultants and bankers has tried to help CEOs improve their success rate. But they've failed.

That's alarming, because the price of failure is rising sharply. Until this year, companies could bury their bad deals on their balance sheets as goodwill--basically the difference between what they paid and the value of the assets that they acquired. Goodwill was quietly expensed over a period as long as 40 years. No longer. As AOL Time Warner Inc. (AOL) shareholders are painfully aware, companies now have to take a write-off straight away if the assets deteriorate in value. In April, AOL took a \$54 billion charge, a record. Other painful big-ticket reminders of bad deals have followed.

Scrutiny of mergers is only going to become more intense. Under rules adopted by the Financial Accounting Standards Board last year, companies have to explain in more detail why they are making an acquisition. They have to tell what assets, including intangible ones, such as goodwill and patent rights, they are getting for their money.

Why did CEOs do so many deals in the six years we studied? The bull market was a big reason, of course. Executives were brimming with confidence and rich stocks. "Mergers are a valuation-driven phenomenon," says Robert W. Vishny, a professor at the University of Chicago Graduate School of Business who specializes in corporate financial behavior. Only the high and disparate stock valuations across companies in the market could fuel so many deals in so many industries at premium prices at the same time, he says. Of course, executives had to offer plausible strategic reasons to their shareholders for putting their companies through the wringer of a merger. The most common rationales for change were industry deregulation (such as in telecom and energy), the need for consolidation and productivity gains, and opportunities to expand into global markets. "The market doesn't always believe it, but you do your best to make a good synergy story," says Vishny.

In the late 1990s, growth stocks dominated the market and investors clamored for companies with rising earnings per share. One easy way to juice earnings was to buy other companies. A company with a high price-earnings ratio could easily juice its own short-run earnings by buying one with a low p-e--even if the purchase delivered poor returns in the long run. At the same time, big institutional investors favored companies with bigger stock market valuations so they could trade in and out in a hurry. So desperate CEOs began paying high premiums to snare any deal that would push up their earnings and market cap.

Meantime, the bull market handed CEOs a potent deal currency: highly valued stock. It's better than cash, because CEOs can print stock almost at will. But when they pay with paper, CEOs tend to get into

riskier deals. Some executives even argued that high stock valuations were the market's way of telling them to buy. "Companies were focused on the signals they were getting from the market, and those signals were misleading," says one banker.

Of course, stock does have some big advantages. Unlike cash borrowed to make an acquisition, it doesn't have to be repaid. Besides, it reduces debt-to-equity ratios and conserves cash reserves. It also dilutes shareholders' interests--a real cost, but one that is often ignored. "Paying with stock is a strong signal that not only do you think your shares are overvalued but that you are not totally confident about the success of the deal," says Sirower.

Another telltale mark of fatal chutzpah was the premiums CEOs offered: an average of 36% above the seller's market price one week before the deal. With high premiums, buyers are destined to fail unless they can create a lot more value from the takeover than the stock market had recognized. "On a \$1 billion deal [with a 30% premium and fees for lawyers and bankers], you're taking on \$300 million of incremental costs," says Jack Prouty, principal at Step-Change Management LLC, an Annapolis (Md.) consulting firm. "Then you're going to have some critical members of your sales force walking out the door with key customers. You're going to get a dip in business and dig yourself a hole of another \$50 million to \$100 million."

Of course, companies blame post-merger blues on anything but the failings of their own managers. Consider Office Depot Inc.'s ([ODP](#)) \$2.9 billion stock deal for Viking Office Products Inc. in May, 1998. It paid a 42% premium. The market hated the deal and knocked Office Depot stock down 12% on the news. Over the next year, Office Depot underperformed other specialty retailing stocks by 55 percentage points. Investor relations chief Eileen Dunn says Office Depot had to pay up to get fast-growing Viking with its international and mail-order businesses, perfect launch pads for e-commerce, which the company wanted to enter. The problem, she adds, is that the regulators had months earlier scotched Office Depot's planned merger with Staples Inc.: Its real estate acquisition team, key to meeting its growth targets, had bolted in anticipation of the consolidation.

In a roaring bull market, paying the going rate leaves no margin for error. Clear Channel Communications Inc. ([CCU](#)) got into a fix by pursuing the then-hot properties of rival radio station operator AMFM Inc. in October, 1999. The \$17.3 billion price tag was a 41% premium. Over the following year, Clear Channel shares lost 31%, as advertising slowed, cultures clashed, and the AMFM stations needed more investment than planned. Meanwhile, media stocks in the S&P 500 rose 19%. Clear Channel spokeswoman Diane Warren says the price was fair. "The merger has been an outstanding acquisition," she says, and still holds "enormous upside potential." It made Clear Channel the largest radio operator in the nation--sheer size that has spawned lawsuits alleging anticompetitive behavior. The company calls the allegations "absurd."

Some deals just seem poorly thought out to begin with. Department store chain Dillard's Inc.'s ([DDS](#)) May, 1998, acquisition of Mercantile Stores Co. for \$2.9 billion in cash seemed a logical expansion from the South into Ohio and the Midwest. But the two retailers had dramatically different marketing strategies. Mercantile was well-known to its customers for its "Midnight Madness" sales; Dillard's was far more conservative and avoided promotions in favor of an everyday-low-pricing strategy. Dillard's

overstocked the Mercantile stores as it switched strategies. Customers balked, forcing Dillard's to deeply discount the goods. Its shares lagged peers by 55 percentage points a year after the deal. "The acquisition set Dillard's back a couple of years," says analyst Robert F. Buchanan of A.G. Edwards Inc. "It gave them a prolonged case of indigestion." Dillard's did not return calls asking for comment.

Indigestion is a common post-merger malady. It afflicted Harmonic Inc. ([HLIT](#)) after it bought the core of the former C-Cube Microsystems Inc. for \$1.7 billion in October, 1999. Harmonic, whose stock had risen elevenfold within a year, wanted C-Cube's equipment to carry broadband delivery of the Internet by satellite. But several key execs left, sales growth collapsed, and so did Harmonic's stock, down 86% a year later, 99 percentage points below communications equipment stocks. CEO Anthony J. Ley says the stock fall reflects weaker demand from his customers, and that the merger was a successful and necessary step to diversify his products: "We're much more likely to be around for the long haul," he says. But Ley also says he's wary of M&A: "It's fraught with danger. It requires very little to screw up completely."

Acquisitions also go bad when buyers don't know exactly what they're getting. That happened even to savvy investor Warren E. Buffett. He announced his \$21.7 billion deal to buy General Reinsurance Corp. for stock the afternoon of Jun. 19, 1998, right after Berkshire Hathaway Inc. ([BRK](#)) shares closed at their all-time high. That gave him some margin for error, but not enough. He discovered ultimately that General Re had taken risks it couldn't evaluate and had underpriced much of its business. The market caught on early: By the time the deal closed six months later, Berkshire shares were down 25%. A year after the initial announcement, they were lagging insurance stocks in the S&P 500 by 19 percentage points. Later, Buffett apologized to his shareholders.

Of course, some deals that appear to be flops still leave shareholders better off than they would have been otherwise. Indeed, for a CEO whose business faces a disastrous decline, a deal may be a victory if it manages just to keep his company alive. "Because the market reacts to an acquisition negatively doesn't always mean it was a bad idea," says Chicago's Vishny. "The stock may have gone down worse if it hadn't been used to buy real assets." Consider chipmaker Advanced Micro Devices Inc.'s ([AMD](#)) October, 1995, deal to buy competitor NexGen Inc. for \$860 million. AMD's stock lost 37% in the next year, 63 percentage points worse than peers. But had AMD not acquired NexGen's computer-processing chip technology, it would have been unable to compete with Intel Corp. ([INTC](#)) and go on to produce its successful Athlon rival to Intel's Pentium chips. "This was basically a Hail Mary play to stay in the game," says founder W.J. Sanders III, who made the deal. "Without it, we were out of the processing game forever. It was a good deal then, and I still think it is a good deal."

The ultimate could-have-been-worse case is AOL Time Warner. Measured as a media deal it was a bust. AOL shares lost 37% over a year relative to other media companies. But at the time, AOL was an Internet company. So, although its shares plummeted 49% in the year after the announcement, it was still in business when other Net stocks crashed and burned. In effect, AOL boss Stephen M. Case persuaded Time Warner CEO Gerald M. Levin to trade valuable media assets for bloated AOL stock. That may be cold comfort to AOL investors--and infuriating to Time Warner's, who could have sold in the first week and cashed in the 17% premium on their stock. A year later, Time Warner shares were 9% below what

they had been a week before the bid. AOL Time Warner declined to comment.

Our findings point to the need for CEOs and directors considering deals to get them right--or let them pass without a second thought. "The best thing companies can do is make sure M&A is a tool used in corporate strategy," says Sirower. "Instead of reacting to deals that come along, companies should only make acquisitions they need for a specific purpose."

With their stocks limping, the market tumbling, and the economy faltering, buyers are less cocky about deals already. "Going forward, there will be heightened concern over what companies pay and whether the synergies are real," says Goldman's Levy. "Everyone is going to be more cautious." After what buyers put their shareholders through in the 1990s, it's about time.

By David Henry

With Frederick F. Jespersen in New York

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