

Deal Terms in the Big Transactions of the Nineties

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Overview

The 1990s have been called the era of strategic mergers. Powerful change forces have transformed the economic and financial environments. Global markets and exploding technologies have blurred industry boundaries and intensified competition. Strong economic growth and a rising stock market have rewarded the leaders and penalized the laggards. These pressures have forced business to develop a broad arsenal of M&As, divestitures, joint ventures, and restructuring in the effort to achieve profitable growth.

Deal Terms

We look at a sample of 364 transactions that account for almost half of the total M&A values between 1992 and mid-1998 to reveal deal patterns. Overall, pooling (to be prohibited by the end of 2000) accounted for 52% of the big deals. Pooling accounted for 80% of bank mergers, but only 45% of non-bank mergers. So the end of pooling will affect less than half of non-bank mergers.

In the 80s, debt and cash from debt sales accounted for the predominance of transactions. In the 90s, stock-for-stock deals account for 80% of the big transactions. Financing is readily available for the other 20%. Eighty-five percent of bank mergers were non-taxable, mostly poolings. Only 60% of non-bank mergers were non-taxable. When acquisitions were treated as purchases, at least 70% were taxable.

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Premiums

The premiums paid over the market price of the target 30 days before the announcement was about 40% whether the accounting method used was pooling or purchase. But in purchase transactions that were taxable, the target received a 42% premium versus 34% when non-taxable. The buyer seems to pay at least part of the taxes.

Stock Market Reactions

Stock market reactions to the deals are measured over a 30-day window beginning 20 days before the announcement date, ending 10 days after. The stock prices of non-bank buyers went up for 52% of the companies when the deals were announced. On the seller or target side, 90% were positive for the non-bank transactions. The predominance of positives for the targets is not surprising since risk arbitrage tends to push the prices toward the purchase price (with exceptions). But the same risk arbitrage activity usually involves shorting the buyer while going long on the target. When the market judges the deal to make good business sense, this overcomes the selling pressure which occurred for 52% of the non-bank deals which had positive stock market gains. However, for banks, the market seems to question whether efficiencies will be achieved and so negative price responses for buyers occur 62% of the time.

The deals for which the stock market reacted positively less the negatives gives a net gain of \$48 billion for non-bank buyers and a net gain of \$99 billion for non-bank sellers. Banks did not fare as well. Bank buyers had a net negative market response of \$15 billion while sellers gained \$22 billion.

This is an overview of patterns of the big transactions of the 90s. Perspectives are provided for deal makers. Assurances are provided to policy makers that on these big transactions overall the market has judged them to make sound business sense.

Academic studies show that the initial stock market response to merger announcements is a good predictor of future performance. Will these predictions hold for the future? The optimism of the times may require some reservations. But the strong change forces suggest that the many responses by business reflect sound entrepreneurial responses.

With this general summary, we next present a more detailed analysis of the patterns of deal structuring for the big deals of the nineties. We will cover accounting treatment, method of payment, taxability, premiums paid, and measurements of stock market reactions.

Sample Selection

This paper seeks to put the merger movement of the 1990s into perspective. The merger movement of the 1980s peaked in 1988 at \$238.5 billion as shown in Table 1. Legislative and economic forces resulted in declines in M&A activity in 1989 through 1991. A resurgence of M&A activity began in 1993. Each successive year thereafter recorded a substantial percentage increase in M&A activity over the previous year reaching \$1.3 billion in 1998.

The M&A activity of the 1990s included many large transactions. It is useful to analyze in some detail the blockbuster transactions whose characteristics differ from the patterns for total transactions which by number would be predominantly smaller deals. Our sample consists of 364 transactions, representing 48.5% of the total dollar value as shown in Table 2. Our selection criteria began with all M&As in which the price paid for

the target exceeded \$500 million. By 1997, this annual number became so large we raised our cutoff to \$1 billion or more.

Our study ended with transactions announced through June 1998. The stock market adjustment which began in July 1998, dampened new M&A deal announcements. For completed transactions, however, the third quarter of 1998 was still high because of deals initiated earlier. The stock market began to recover in mid-October and was associated with a resumption in an active M&A market, with 11 major deals totaling \$65 billion, announced on "Merger Monday" (Wall Street Journal, November 23, 1998, and Los Angeles Times, November 24, 1998). Thus, our study captures a distinctive cycle of M&A activity. The annual pattern of the large firm M&A activity is shown in Table 2. Our sample accounted for about 40 to 45% of total deals in most years, rising to almost 69% for the first half of 1998. The exploding number of blockbuster transactions is consistent with our data.

Deal Structuring in the Big Mergers of the Nineties

Surprisingly the rules governing the accounting treatment of mergers and takeovers had not been fundamentally changed since the 1970 Guidelines issued by the Accounting Principles Board (APB) of the American Institute of Certified Public Accountants. Its Opinion 16 specified the 12 conditions required to use pooling accounting, and Opinion 17 dealt with the treatment of goodwill involved in purchase accounting. Pooling of interest accounting permits the financial statements after a merger or takeover to be the simple addition of all balance sheet and income statement accounts. In purchase accounting, the excess of the market value paid over the book net worth of the seller is first assigned to existing tangible assets and the remainder is goodwill to be

written off over 40 years. This write-off is generally not tax deductible and so reduces the bottom line net income figure when purchase accounting is used.

The successor to the APB, the Financial Accounting Standards Board (FASB), announced in its Bulletin No. 197-A/May 18, 1999, that it had voted unanimously to eliminate pooling of interest as a method of accounting for business combinations. FASB stated that the change will become effective after it issues final standards in late 2000.

Published data do not provide systematic numbers on the extent to which pooling versus purchase methods of accounting are employed. But this information is available in proxy statements sent to shareholders in connection with approvals for transactions. We obtained copies of these proxy statements for our 364 companies. From these, we compiled data on accounting treatment as well as method of payment, taxability, premiums, and initial stock market reactions.

Pooling Versus Purchase Accounting

Transactions that use purchase accounting involve a larger firm buying a smaller firm. Since one of the 12 requirements for pooling accounting is that the firms be of approximately equal size, the acquisition of smaller firms by larger firms would have to receive the accounting treatment of a purchase transaction. Our sample of the 364 largest transactions between 1992 and June 30, 1998 accounted for 44% of total transactions over the entire period and for 69% for the first half of 1998. The number of total transactions in the M&A Almanac in 1998 were 9,149 and 7,759 for Mergerstat. Thus, most of the 8,000-9,000 annual transactions in the broader compilations represent purchase accounting.

For our sample of 364 transactions, pooling accounted for slightly more than 52% of the transactions, as shown in Table 3. However, 75 of the 364 transactions (20.6%) involved banks. For banks as shown by Table 3, 80% of the transactions were pooling, only 20% purchase. For our non-bank sample, purchases predominated at 55% of the total. The data indicate that banks had a very strong preference for pooling. One possible explanation is that the banks are strongly averse to the negative impact of goodwill write-offs on reported net income. In contrast, in non-bank transactions, the strong avoidance of non-pooling transactions does not manifest itself. One possible explanation is that in general the economies or synergies in the non-banking transactions are sufficiently strong so that the negative effect of the goodwill write-off is overcome by the increase in earnings that the new combined firm will be able to achieve. We discuss this further below. The point is that firms in highly synergistic transactions would be less averse to the negative impact of the goodwill write-off since the increase in earnings of the combination will more than offset the negative effects. This also leads to the prediction that highly synergistic mergers will not be deterred when after 2000 the use of pooling accounting may no longer be available in merger transactions.

Method of Payment

The 80s are referred to as the decade of mergers propelled by junk bond financing. The debt sold raised cash which was used in takeovers, often hostile. Data compilations showed these deals as cash transactions, but the underlying source was debt. During the 1990s, our data show that in the 364 largest deals as shown in Table 4, stock accounted for 60% of the number of transactions with combinations of stock and cash moving the proportion up to 80%. Stock-for-stock transactions are generally non-

taxable. In bank mergers, stock is involved in over 90% of the deals. In non-bank mergers, the proportion drops to about 75%.

In large compilations of transactions most by number would be smaller deals. These smaller transactions are typically made for cash. Thus, in broader compilations we find that stock is involved in about one-third of the transactions. A brief generalization is that big deals in the 90s have been mainly stock-for-stock. In the smaller deals, the seller is likely to be paid off in cash.

Taxability

Table 5 shows that for non-bank transactions, 60% are non-taxable. Table 3 showed that 45% of non-bank deals are accorded pooling of interest accounting treatment. Pooling deals are generally non-taxable. Hence, the additional 15% of non-taxable, non-bank transactions used purchase accounting, but still qualified for non-taxable treatment. The reason for this is that some stock-for-stock transactions might not meet all of the 12 rules required to qualify for pooling of interests accounting. For example, if one of the participants in a merger had engaged in stock buybacks during the two years preceding the year of the deal, it would fail to qualify for pooling of interests treatment. But since it was a stock-for-stock transaction, it could still qualify for non-taxability.

Table 6 shows that about 54% of all non-bank transactions in which purchase accounting was used were taxable transactions. In another 19%, taxability depended on whether the seller chose to take cash or stock when this election option was provided by the buyer.

Over 85% of bank transactions are non-taxable. This reflects the predominance of pooling in bank deals. If we add the 6.7% of bank deals in which the buyer offers the seller the option to take cash or stock, we find that probably over 90% of the bank deals qualified for non-taxability.

Premiums Paid

We next consider the premiums paid by sellers. We measure the premium based on the market price of the seller stock 30 days before the public announcement of the deal. We did this to try to avoid the runup in price of the seller stock in response to the leaks that occur predominantly in the 5-10 days before the formal public announcement date.

The 30-day percent premium was about 40% for the seller in non-bank transactions when an arithmetic mean is used to average over the deals. In an arithmetic average, the larger numbers receive a higher implicit weighting. To avoid this we also use as a measure of the average the median firm for which half of the sample is above and half below. This gives less weight to the larger numbers so that the median falls to 33% for pooling transactions and 37% of purchase transactions, as shown in Table 7.

When the purchase accounting non-bank transactions are grouped by taxability, the target received a 42% premium as compared with a 34% premium in non-taxable transactions. This implies that the buyer pays more when the seller is in a taxable transaction.

As a general guideline, for the big deals the pattern has been premiums paid over the seller market price 30 days before the formal announcement date from about 33-40%

for non-taxable, non-bank deals. For taxable non-bank deals, the premiums to sellers appear to jump by 3-4 percentage points.

Analysis of Event Returns

Empirical studies have found that the initial market reactions to merger announcements are good predictors of subsequent performance. These initial market reactions are measured by statistical procedures which measure stock price changes individually for acquiring firms and target firms for periods both before and after the announcement dates. These stock price changes are adjusted for contemporaneous general stock market movements. The resulting residual represents market price changes net of general market movements associated with the distinctive event (for example: mergers, new stock issue, product defects, executive changes). For a large sample of companies, the average stock price change net of market movements would be expected to be zero since a large sample would mimic market behavior. For a sample based on a common event such as mergers, with changes measured around the event date such as the merger announcements, positive or negative differences from general market movements are referred to as abnormal residuals from market movements, or event returns. Healy, Palepu, and Ruback (1992) found that event returns for a sample of the largest 50 merger transactions between 1979 and mid-1984 were significantly correlated with a number of measures of accounting performance during a five-year period subsequent to the merger announcements. So the event returns are one measure of whether the market evaluates an announced transaction as one that is likely to be a successful or good merger versus an unsuccessful or bad merger.

We calculated positive and negative gains for our sample. Stock price data were not available for all transactions, so for this analysis, our sample size drops from 364 to 309. We multiplied the positive or negative net percentage gains or losses times the market value of equity for the acquirer and the target, 20 trading days before through 10 trading days after the announcement date. The results can thereby be presented in absolute dollar terms. The dollar returns to targets, measured over the 30-day window, are almost always positive. The event returns for the acquiring firm will be positive or negative depending on the market's judgment of whether the premium paid to the seller by the buyer will be recovered in the subsequent performance of the combined firm.

Table 8 presents the overall results for our event return analysis. For the total sample, about two-thirds of the deals had positive returns. This provides one measure of whether M&As are successful in some sense. Our results suggest that two out of three large mergers are likely to add value to shareholders. Looking at the bank subsample alone, the percentage of predicted success drops somewhat. Without banks, the success ratio is slightly higher.

In Table 9, we look at the absolute dollar amounts involved. In the non-bank sample, when we add the dollar amount of increases in the market cap of the buyer over the 30-day window of 20 days before and 10 days after the formal announcement date, the positive gains of \$130 billion exceeds the deals where the buyer suffered stock price losses of \$82 billion, for a net gain to buyers of \$48 billion. The stock market response for sellers is usually positive. So the total of plus event returns of market cap increases was \$109 billion for sellers less negatives of \$10 billion, leaving a net plus \$99 billion for sellers. Bank buyers had net losses of \$15 billion while bank sellers had net gains of \$22

billion. So even for bank transactions the gains of sellers did not simply represent a shift based on the losses in market value of the buyers.

We also analyzed stock market gains and losses stratified by method of accounting, taxability, etc. However, the differences are not statistically significant. Our judgment is that the business soundness of the deal determines how the stock market will react. If the market judges the deal will work out well in the future, the initial market response is likely to be favorable. If the market judges the deal to be misconceived and not have a sound business foundation, it will react negatively. Whether the deal is soundly conceived or not determines whether the stock prices of the sellers and/or buyers will increase. The method of accounting used, or taxability, are of secondary importance. The important lesson is, good deals will assuredly increase market prices for the sellers and even for the buyers despite some initial shorting by risk arbitrage traders. Bad deals will be bad news for shareholders, both for the acquiring firms and ultimately for the selling firms.

References

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Table 1
Merger Completion: M&A Magazine

	No. of Deals	% Change	Value (\$ bil)	% Change
1979	1,530	-	34.2	-
1980	1,560	2.0%	32.9	-3.8%
1981	2,329	49.3%	70.1	113.1%
1982	2,298	-1.3%	60.7	-13.4%
1983	2,391	4.0%	52.7	-13.2%
1984	3,164	32.3%	126.1	139.3%
1985	3,437	8.6%	145.5	15.4%
1986	4,381	27.5%	204.9	40.8%
1987	4,037	-7.9%	178.3	-13.0%
1988	4,049	0.3%	238.5	33.8%
1989	3,828	-5.5%	323.9	35.8%
1990	4,324	13.0%	207.5	-35.9%
1991	3,605	-16.6%	141.2	-32.0%
1992	3,762	4.4%	124.9	-11.5%
1993	4,171	10.9%	178.2	42.7%
1994	5,000	19.9%	276.9	55.4%
1995	6,309	26.2%	384.8	39.0%
1996	7,127	13.0%	560.2	45.6%
1997	8,156	14.4%	768.9	37.3%
1998	9,149	12.2%	1,323.3	72.1%

Source: Mergers and Acquisitions Annual M&A Almanac issues.

Table 2
Deal Size of Sample

Year	Number of Sample Deals	Dollar Values of Sample Deals (\$bil)	Percent of Total Sample	Dollar Values of Total Deals (\$bil)	Sample Percent of Total Deal Values
1992	16	16.9	1.3%	124.9	13.5%
1993	24	72.7	5.4%	178.2	40.8%
1994	44	79.9	5.9%	276.9	28.9%
1995	68	160.5	11.9%	384.8	41.7%
1996	86	223.5	16.6%	560.2	39.9%
1997	68	262.2	19.5%	768.9	34.1%
1998*	58	531.5	39.5%	773.1	68.7%
	364	1,347.2	100.0%	3,067.0	43.9%

* First 6 months of 1998.

Table 3
Accounting Treatment, 1992-1998

Method	Bank		Non-Bank		Combined	
	Number	Percent	Number	Percent	Number	Percent
Pooling	60	80.0%	130	45.0%	190	52.2%
Purchase	15	20.0%	159	55.0%	174	47.8%
Total	75	100.0%	289	100.0%	364	100.0%

Table 4
Method of Payment in Largest Mergers, 1992-1998

Method	Bank		Non-Bank		Combined	
	Number	Percent	Number	Percent	Number	Percent
Cash	7	9.3%	72	24.9%	80	22.0%
Stock	61	81.3%	159	55.0%	219	60.2%
Cash and Stock	7	9.3%	57	19.7%	64	17.6%
Debt	0	0.0%	1	0.3%	1	0.3%
Total	75	100.0%	289	100.0%	364	100.0%

Table 5
Taxability, 1992-1998

Method	Bank		Non-Bank		Combined	
	Number	Percent	Number	Percent	Number	Percent
Taxable	6	8.0%	85	29.4%	91	25.0%
Non-Taxable	64	85.3%	174	60.2%	238	65.4%
Election	5	6.7%	30	10.4%	35	9.6%
Total	75	100.0%	289	100.0%	364	100.0%

Table 6
Purchase Accounting and Taxability, 1992-1998

Method	Bank		Non-Bank		Combined	
	Number	Percent	Number	Percent	Number	Percent
Taxable	6	40.0%	85	53.5%	91	52.3%
Non-Taxable	4	26.7%	44	27.7%	48	27.6%
Election	5	33.3%	30	18.9%	35	20.1%
Total	15	100.0%	159	100.0%	174	100.0%

Table 7
30-Day Percent Premium

Accounting Method	Tax Treatment	Bank		Non-Bank		Combined	
		Mean	Median	Mean	Median	Mean	Median
Pooling	Non-Taxable	44%	35%	40%	33%	41%	34%
Purchase	Total Purchase	36%	34%	41%	37%	40%	37%
	Taxable	23%	12%	42%	37%	41%	37%
	Non-Taxable	48%	41%	34%	36%	35%	36%
	Election	34%	45%	52%	49%	47%	46%

Table 8
Percentage of Positive and Negative Total Gains

		Buyer		Seller		Combined	
		Number	Percent	Number	Percent	Number	Percent
Banks	Positive	27	38.0%	63	88.7%	41	57.7%
	Negative	44	62.0%	8	11.3%	30	42.3%
Non-Banks	Positive	124	52.1%	213	89.5%	161	67.6%
	Negative	114	47.9%	25	10.5%	77	32.4%
Total Sample	Positive	151	48.9%	276	89.3%	202	65.4%
	Negative	158	51.1%	33	10.7%	107	34.6%

Table 9
Summation of Positive and Negative Total Gains
(\$ Millions)

		Buyer	Seller	Combined
		Banks	Positives	12,782
	Negatives	(28,191)	(3,946)	(20,162)
	Sum	(15,409)	22,060	6,650
Non-Banks	Positives	129,675	108,880	213,947
	Negatives	(81,641)	(9,723)	(66,756)
	Sum	48,034	99,157	147,191
Total Sample	Positives	142,457	134,886	240,759
	Negatives	(109,832)	(13,669)	(86,918)
	Sum	32,625	121,217	153,841