Sacred Heart University Review

Volume 16
Issue 1 *Sacred Heart University Review, Volume XVI, Numbers 1 & 2, Fall 1995/ Spring 1996*

Article 8

1-1-1996

Restructuring Corporate America by John J. Clark, John T. Gerlach, and Gerald Oslo

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John J. Clark, John T. Gerlach, and Gerald Oslo, *Restructuring Corporate America*. New York: The Dryden Press, 1996. 436 pp. $65.00.

by Darryl C. Aubrey

One cannot read newspapers or news magazines without becoming aware of the rapid transformation of American businesses, generally described as ``restructuring." Much has been written about mergers and acquisitions, divestitures, downsizing, Total Quality Management, reengineering, globalization, and other forms of corporate change. But the popular press has not fully explored or explained the financial considerations of restructuring. What forces have brought these changes about and what forms have the changes assumed? These are the issues addressed in *Restructuring Corporate America*, by John Clark of Drexel University, Gerard Olson of Villanova University, and John Gerlach, currently the MBA Director at Sacred Heart University. This is a textbook, discussing in detail, with many case studies and concrete illustrations, such subjects as refinancing, management realignments, leveraged buyouts, employee stock ownership plans, and responses to bankruptcy. But more than a textbook, it is a well-researched and extensively documented comprehensive history of mergers, acquisitions, and financial restructuring in the United States.

The first part of the book analyzes various types of restructuring. It is a rare business that can succeed by adhering to a single formula over time. The emergence of new technologies, demographic trends, new sources of natural resources, social attitudes, political alignments, and other exogenous factors force business firms to change over time or perish. These forces for change are not recent developments but have always been present. One contribution of this book is that it places restructuring into an historical perspective, and the authors show that in response to a variety of pressures and needs, mergers and acquisitions can take a number of forms. *Horizontal combinations* are mergers where the companies involved produce one or more of the same, or closely related, products in the same geographical markets. An example of this form of merger would be Foremost Dairy Products, which acquired 59 local dairy companies between 1948 and

1960. Similar combinations are now occurring in the banking industry. *Vertical combinations* are mergers where the two companies involved had a potential buyer-seller relationship prior to the merger. An example is U.S. Steel, which at its zenith, had extensive holdings in iron ore reserves, coal and coke properties, rail and water transportation companies, and natural gas facilities. *Product extension combinations* are where the companies involved are functionally related but do not compete directly with one another. An example would be a soap manufacturer acquiring a bleach manufacturer. *Market extension combinations* are where the companies involved manufacture the same products but sell them in different markets. An example would be a milk processor in Washington acquiring a milk processor in Chicago. This type of merger extends the market area covered by the acquiring firm. *Pure conglomerate combinations* are where the combining firms are unrelated. An example would be a shipbuilding firm acquiring an ice cream manufacturer. The first four forms are motivated by seeking business synergy while in the latter case the primary objective is diversification.

Mergers are not recent innovations. The authors present statistics of merger activity for more than 100 years. Four waves of mergers since 1895 have been identified. The first wave, from 1895 to 1905, was driven by changes in incorporation laws of the states allowing a corporation to own stock in another, as individual states competed to attract corporations. The second wave, from 1922 to 1929, was driven by relaxation in the application of anti-trust laws coupled with the economic boom that preceded the stock market crash of 1929 and the great depression. The third wave, from 1950 to 1968, was also driven by changes in the legislative environment. In this case, legislation became more restrictive for horizontal and vertical extensions and companies engaged in unrelated combinations with diversification as the primary motivation. These combinations were mostly financed by the exchange of common stock and issuance of convertible securities. The fourth wave, which began in 1975, was financed by cash and cash equivalents and an increasing number of hostile takeover offers.

As foreign trade has increased and businesses have become increasingly international, government policies and regional trade agreements to manage trade have affected restructuring, joint ventures, and international corporate alliances. For example, potential government response to the success of Japanese auto manufacturers in the United States first resulted in voluntary trade restraints on the part of Japan which were soon followed by the establishment of Japanese manufacturing plants in the United States and joint ventures between U.S. and Japanese firms. By the end of 1990 Japanese companies were operating 13 plants in the United States in joint ventures with General Motors, Ford, and Chrysler.

The authors next turn to a discussion of how restructuring not only involves changes in the organizational structure, but also concerns how the firm is financed, particularly the debt to equity ratio and the cost of capital. Finding the best (that is, the lowest cost) method of financing has the same effect on the firm's profitability as lowering manufacturing or other costs or increasing sales revenue. If everything else is equal, it will also increase the market value of the common stock and the value of the enterprise.

The sale of securities as an initial public offering or IPO is a major financial restructuring decision taken by the owners of the enterprise. In return the owners now obligate themselves to manage the business, not for themselves alone, but now for the new owners — the stockholders. Privately owned companies seeking funds for growth and also seeking to reduce debt may undertake IPOs as well as leveraged buyouts and spin-offs. Spin-offs are divisions or subsidiaries for which the enterprise no longer see a strategic purpose — hence divestment. Investment bankers play a key role in bringing an IPO to the market. The investment banker may sell the securities on a ``best efforts'' basis or may guarantee the sale by agreeing to buy all of the securities for resale to the public. Research reveals that over the long term IPOs tend to increase the wealth of the company insiders and underwriters more than investors. There are notable exceptions however, such as Microsoft, where an initial investment of $10,000 is now worth about $800,000!

A recent form of financial restructuring that exploded in the 1980s is the leveraged buyout or LBO. In 1988 alone there were some 300 LBOs with a value of about $100 billion. The distinguishing characteristic of the LBO is the very high debt levels, as high as 95 percent. This also gave rise to the ``junk bond'' — a high yield bond that is not fully supported by assets and not rated by the rating agencies. A new form of investment banker came into existence to serve this market and new forms of debt were created. LBOs were a favorite way of accomplishing spin-offs where management would buy the division or subsidiary though the issuance of junk bonds. Enthusiasm for this form of financial restructuring led to high prices and subsequent failures of a number of prominent companies. The text deals extensively with techniques to determine the value of an LBO.

Another form of financial restructuring is the Employee Stock Ownership Plan or ESOP. A 1974 law created the ESOP as a way to encourage employee ownership of corporations. Corporations were given tax breaks for money contributed by the corporation to buy stock for its employees. Initially ESOPs were primarily fringe benefits for employees of large corporations which provided long term savings. Over time ESOPs came to be established as takeover defenses which are now being tested in the courts. Most financial observers believe that ESOPs are aligning the interests of workers and management and making our economy more competitive.

The last form of financial restructuring discussed is brought about by companies in distress seeking an opportunity to reorganize through bankruptcy. This form of restructuring can be voluntary or brought about by court decisions. Companies may enter bankruptcy because of inability to pay bills or by the threat of massive awards against the company through lawsuits. There are two forms of bankruptcy: Chapter 7, dealing with liquidation, and Chapter 11, which allows the firm to reorganize. In both cases either the debtor or the creditors file a petition with the federal bankruptcy court. Reorganization under Chapter 11 allows the company to survive while a plan to satisfy creditors is developed. However the process is expensive, time consuming, and inefficient. Alternatives to bankruptcy for a distressed firm are acquisition by a ``white knight'' or bailout by special legislation, such as in the case of Chrysler.

The second part of the text then turns to discuss issues of strategy and tactics, both offensive and defensive. The authors note that ``Acquisition to acquire control of assets — whether by merger, purchase, or lease — are capital projects and, therefore, have to meet the same financial criteria established by the firm for inclusion in the capital budget'' (p. 263). Once the merger prospects have been identified, the next step is to establish the boundary conditions or bargaining area for the negotiation. In the case of a stock swap, this results in the maximum exchange ratio that would be acceptable to the acquiring firm's stockholders and the minimum ratio that would be acceptable to the stockholders of the firm to be acquired.

The authors then turn to the issues of accounting and taxes, which affect the profitability and tax liabilities for the combined enterprise. Actions to minimize asset values on the books will reduce future costs. For example, if book values of assets to be acquired exceed market values, a ``purchase" treatment allows the assets to be recorded at purchase values. Another example involves how to value goodwill. The text discusses and provides guidelines for these and other accounting decisions, including the closely related area of strategies to minimize the tax consequences of the merger. Tax liabilities are of central concern to the two firms and may affect the structure of the acquisition as well as the accounting choices. In a tax deferred acquisition, the seller incurs no tax liability at the time of the purchase, but only when he or she later sells the stock acquired in the swap. The IRS requires that the reorganization must have a valid business purpose, other than tax deferral, to qualify for tax deferral.

The text then turns to an excellent review of current anti-trust law in the United States and the impact on corporate restructuring. United States anti-trust legislation is designed to prevent enterprises from achieving monopoly power by restricting activities that tend to diminish competition. Under these laws, mergers and acquisitions that pose a significant risk of reduction in competition can be challenged by the federal government. The guidelines used by the Department of Justice in deciding whether or not to challenge mergers are discussed. It would have been interesting if the authors had considered in more detail the argument that, in our global business world of today and tomorrow, competition should be measured on a global scale rather than a national scale.

Overall, *Restructuring Corporate America* makes a strong addition to one's library of finance and business texts. It not only contains clear and comprehensive discussions of restructuring strategies, but also puts the subject in an historical context and contains summaries of relevant research in the area. It is not light bedtime reading, but well worth the time, especially in an age when restructuring is a major force in the global economy, ultimately affecting individuals as well as corporations.