Excerpts From The Testimony of Alan Greenspan
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The extraordinary increase in recent years of mergers, acquisitions, and leveraged buy outs, is a response to a significant incentive: namely, the perception that the potential value of a takeover candidate could be substantially higher than the cost of acquisition. This potential profit derives mainly from the marked increase in the real cost of capital that occurred at the beginning of the decade, largely as a result of a widening structural budget deficit. While the real cost of capital, as measured either in debt or equity terms, presumably remains above normal, it has fallen a great deal recently. This suggests that the wave of mergers and acquisitions may now be cresting.

American industry generally has been structured in the context of approximately a 5% real cost of capital. Individual corporations, therefore, were structured so that the maximum use of resources would occur at that discount rate. By way of illustration, a petroleum refining-marketing complex, may have been tied to its source of crude oil in such a way that the refining-marketing facilities would be depreciated over the same time period as the depletion of the crude reserves, assuming a set rate of liftings of crude oil to supply the refineries. Assume further that the market value of the crude reserves and the refining-marketing operation (at a 5% discount rate) had maximum value at depreciation and depletion rates which spread the life of both facilities over 20 years. If the real cost of capital then rose to 7%, the refining-marketing complex already in place cannot readily alter its life expectancy, but the rate of depletion of the oil field could be changed. Maximizing the value of the oil field at the higher 7% discount rate implies a more rapid rate of depletion. Therefore, at a higher cost of capital, it makes sense to separate the crude reservoirs from the refining-marketing operation. The separate market value of the two facilities then would, of necessity, total more than the market value of the facilities when linked.

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This simple example while hypothetical, nonetheless, illustrates the problem of fitting various pieces of a company so as to optimize their collective value. Since the process relates to a specific cost of capital, an alternative capital cost almost surely will not generate the same optimum return. But while the cost of capital can change rapidly, the composition of fixed assets can be altered only slowly.

One way to reestablish the maximum value use of facilities is to break apart companies, reconstituting them at their maximum use under the new cost of capital. Markets anticipate this process, gradually revaluing the individual pieces of a misaligned company at more than their value in combination. In 1983, the independently determined market value of individual television stations aggregated virtually as much as the stock market value of entire television networks. These encompassed not only television stations, but also radio stations and publishing. Oil company stocks also reflected far higher implied independent values for disengaged crude oil from refining-marketing than for the total system. So long as the companies stayed in their historical context, however, and generated incomes from that particular linked group of assets, the present value of expected future returns from those facilities for the full, but now suboptimum, life of the assets would create stock market values below their breakup costs.

The ability to take over and reconstitute these companies was, therefore, of considerable market value. As a consequence, the premiums in the stock market for control of companies began to rise very sharply. In the 1970s and earlier, the typical price premium on the critical mass of a company's shares required for control, sold at perhaps 20%-40% over the prevailing stock market values which were generated on the basis of investment in the facility as specifically constituted. In recent years, control premiums have risen to twice the market value of individual investment shares reflecting the profit in stock market values from restructuring a company. This has produced an enormous surge of takeover attempts. Any investor who could buy controlling interest in a company at less than the full control premium could profit from the difference between the acquisition price and the market value of the company under the new, restructured, set of asset relationships.

With stock prices sharply higher, and the real cost of capital declining during the past two years, premiums for control might have been expected to decline. In fact, the forces generating takeover incentives probably would have peaked, and the process might already be exhibiting significant contraction, were it not for the extraordinary expansion in financings coming from so-called "junk bonds". This has extended the potential profit on takeovers and restructuring, by measuring the number of potential corporate acquirers.

It's long been an oddity of corporate finance that risk premiums imposed on lower quality, higher yielding, corporate long-term obligations, currently dubbed junk-bonds, have in recent years appeared to be larger than actual losses seemed to suggest was appropriate. As a consequence, issuers of such bonds, were relatively few in number until recently. A decade ago less than 5% of public corporate bonds outstanding were low-grade bonds. The market began to change radically a few years ago as investors, confronted with falling interest rates, began to look toward higher yielding lower grade bonds to maintain their interest incomes. As yield spreads came closer to actual loss experience, lower grade credits rapidly increased their share of total outstanding corporate debt to almost 15%.

Junk-bonds eventually should rise to their appropriate share of corporate long-term obligations. At that point, the rate of increase in the quantity of such bonds outstanding should slow fairly dramatically. That, of course, will mean a fairly significant decline in the net new issues of junk-bonds. Hence, the current junk-bond explosion must be viewed as a one-shot market adjustment reflecting previous undervaluation. As higher yielding, higher risk obligations find their new niche in the market, their growth is likely to be more in line with overall corporate debt than with the frenetic pace of recent years. Since they will continue to be available to expanding corporations which are more risk prone, this will increase the overall risk of bond default.

Though the takeover, merger, acquisition frenzy probably is in the process of cresting, and is likely to decline as a result of the sharp increase in stock prices, in its wake, the process has left a significant deterioration of the corporate sector. As a consequence of mergers, acquisitions, leveraged buy outs, and corporate stock repurchase programs, the net liquidation of nonfinancial corporate equities has approximated an incredible $230 billion since the beginning of 1984. As the asset side of the corporate balance sheet has continued to expand, the equity liquidation has, in effect, been a substitution of debt. While all of the debt accumulation has not reflected takeover and merger activity, a very substantial part of it is directly or indirectly related to that process. Interest payments as a percent of nonfinancial gross operating income currently are running at approximately 31%, down only moderately from 35% during the peak in 1982 and still three times the level of a quarter century ago. Hence, the huge increase in corporate debt has essentially offset the benefits that could have occurred to corporate fixed charges from the dramatic decline in interest rates over the last five years.

While some takeovers may have forced moribund management into a more effective use of corporate assets, it is difficult to make the case that the markets are functioning in the manner which theory suggests they should. One would assume that the least well run companies generally were subject to takeovers. Cursory evidence of particular takeover targets suggests that the evidence is mixed, at best. A number of rather well run or improving companies have been the subject of successful takeovers merely because their stock prices have not yet fully reflected their improved status.

Of greater importance is the question whether something is fundamentally wrong with a structure of corporate governance that is creating a form of behavior that undercuts the optimum use of capital. In principal, corporations are run for the benefit of their shareholders, within the context of laws that are designed to protect the rights of third parties. Those third party protections, whether for employees, the community, or the environment, are appropriately left to statute. They should not be obligations of corporate management. Such goals might be in conflict with the primary purpose of maximizing the value of the corporation for its shareholders. Endeavoring to run a business through the reconciliation of conflicting purposes leads to the type of inefficiencies nationalized industries so clearly personify.

All takeovers are, of necessity, voluntary in the sense that investors induce shareholders to sell their shares. Therefore, any alteration in the law or its associated regulations must be based on the presumption that the voluntary agreement between the two consenting parties currently violates the rights of third parties. So-called "Green mail" is a third party rights violation. It is essentially an agreement between management and one or more shareholders to buy back their stock at a price not available to the remaining shareholders. Since it is the other shareholders' resources which are being employed to buy back a single shareholder's stock, there is a clear violation of third party, i.e. other shareholders' rights.

Changes in voting rights on existing shares, another discussed change in corporate governance, raises more difficult questions. There is nothing to prevent the existing body of shareholders from unanimously agreeing that henceforth all voting rights on shares of that corporation would be rescinded for holders until the shares were held for a minimum of 6 months, 12 months, 2 years, or whatever. That process would lower the market value of the individual shares of the company. Should the vote to do this be less than unanimous, those shareholders who do not choose to go along would suffer an involuntary reduction in the value of their shares. Hence, it is difficult to justify such actions.

The requirement that all shareholders obtain the same value for their shares in a takeover seems consistent with existing protections of property rights; some so-called "poison pill" activities do not.

It should not come as a great surprise that the vast number of financial transactions currently associated with the restructuring of American Industry are creating very large revenues and profit for the investment banking industry. The sharp rise in the real cost of capital which followed the deterioration of our federal budget outlook has created great pressures to restructure American industry in line with the new higher levels of capital cost. (Pressures to compete internationally also have been a key factor.) This significant above normal rate of return for financial services is of necessity, a short-term phenomenon. It will fade if the pending sharp reduction in the federal budget deficit brings down the cost of capital and dramatically reduces the number of transactions associated with trying to cope with it. Alternatively, the restructuring required to adjust to the new higher cost of capital will be completed, and the abnormal pressure for investment banking services will also decline. The legal prohibition on large well financed commercial banking institutions to offer services comparable with those of investment banking institutions also may have had the effect of restraining supply during periods of intense demand.

It's important however, to recognize that the current abnormalities in investment banking and mergers and acquisitions are temporary. They reflect the markets' endeavors to readjust to abnormalities in the economy's cost of capital, the result not of private, but of government, actions.

In summary, restructuring some of the elements of corporate governance which undercut the rights of shareholders makes sense. Endeavors to alter some of the broad relationships within the financial community which have served us well and are currently temporarily out of alignment does not.