He WROTE the TEXTBOOK on M&A

Academic and author **DR PATRICK GAUGHAN** speaks with Brunswick's **EDWARD STEPHENS**

IN HARDBACK, THE SEVENTH EDITION OF *MERGERS, ACQUISITIONS and Corporate Restructurings* is as intimidating as you'd expect from a nearly 700-page finance textbook. One review calls it "the bible for M&A." The book's been on the curriculum at Dartmouth College and The University of Pennsylvania's Wharton School. It's one of the thickest tomes on the shelves in Brunswick's New York office, weighing in at just under three pounds.

I spoke with Dr Patrick Gaughan (pronounced GAW-gen), the book's author, as the latest edition was set to be released in late 2017. He wrote the first edition while teaching graduate courses at Fairleigh Dickinson University in New Jersey, amid the M&A and hostile takeover boom of the 1980s. "There was no textbook on M&A, believe it or not. Professors just lectured from their handwritten notes and wrote on the board – you have to remember, innovation back in those days was having overhead slides."

The book took "about a year or two" to write, the material coming largely from Gaughan's lecture notes. It went on to win Book of the Year in accounting from the Association of American Publishers.

Over three decades, Gaughan incorporated the latest studies and data into each subsequent revision. The latest edition includes, for example, recent studies that suggest PE funds do in fact outperform the S&P 500, contrary to what earlier research had suggested. Other data bolsters conventional wisdom – the stock price of a target company tends to go up after a deal is announced, while the acquirer often suffers in the short term, paying a premium the market struggles to justify (the average premium today, according to Gaughan, tends to be 30 to 40 percent above market value).

These updates and revisions are not light undertakings, given the sheer volume of research to sift through. "M&A is the most researched of all areas of finance, including securities and investments," says Gaughan. "I guess a lot of people in the world of finance find M&A interesting." I ask if at social events he attends, there are any stories he tells about M&A to try and make the topic interesting for people outside the world of finance. Gaughan laughs. "In my experience, most people at dinner parties don't want to talk about M&A, especially with an academic."

He doesn't give himself enough credit. Not much later, he's telling me about the remarkable back-and-forth takeover battle in the 1980s between US companies Bendix and Martin Marietta, where Marietta used what is wonderfully known as the Pac-Man defense – "so-named after the popular video game in which characters try to eat each other before they are eaten themselves," as Gaughan explains in his book (see Page 71 for more on the Bendix v. Martin Marietta battle).

Gaughan, who holds a PhD in economics, still lectures, teaching at the University of International Business and Economics in Beijing. The economic and financial consulting firm he leads, Economatrix Research Associates, works with a number of Fortune 500 companies.

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DR PATRICK GAUGHAN

A professor of economics and finance at the University of International Business and Economics in Beijing, Dr Patrick Gaughan has written or edited 10 books, including *Mergers, Acquisitions, and Corporate Restructurings*. Gaughan is also president of Economatrix Research Associates, a consulting firm that works with Fortune 500 firms. He holds a PhD in economics.

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And he still writes as well. Gaughan has edited or written 10 books, including *Mergers: What Can Go Wrong and How to Prevent It*, and *Maximizing Value through Mergers and Acquisitions*. He tells me he's currently halfway through book No. 11. "It's going to be on military history, the Pacific theater in World War II," he says in an answer I in no way saw coming. Sensing a question in my silence, he says, "It's a hobby and passion of mine."

For how much he has written on deals, Gaughan admits that people can be surprised to learn he's "a bit of a critic of M&A." Not because he believes deals are inherently flawed, but rather that the people leading them seem to repeat the same, largely avoidable mistakes.

"There's a body of very, very pragmatic empirical research in this field of M&A. And I think it's a fair statement that a lot of people doing deals have virtually no awareness of it. Yet, the research literature really reflects the historical experience of so many other companies and their CEOs, the deals that they did, and what worked, and what didn't.

"But not only do some people not know the history of M&A," Gaughan says, "others don't *want* to know it. Because if they're proposing a deal that wouldn't be consistent with the research literature, they don't want to hear that. They just want to do that deal."

Gaughan contrasts this with medicine, where fluency in research literature is seemingly a prerequisite for practitioners.

A place to begin instilling this knowledge, Gaughan believes, is the boardroom. "If you're going to serve on the board, particularly for companies that do a lot of deals, you should have to attend seminars led by people familiar with the research literature. That way directors can bring a perspective on each deal. What does the research say? What works, and what doesn't work? When things don't work, what are causes of it? And how can it be fixed?"

Those who studied the research literature would see that many of history's best deals, according to Gaughan, have been between businesses that are intimately familiar with one another, citing Pfizer's 2000 acquisition of Warner-Lambert and the 1999 merger of Exxon and Mobil. "Deals in your own industry, businesses that you know well, have a much higher probability of being successful than diversifying deals, where you acquire businesses totally different than your own. The track record of diversifying deals is really poor." The market prices that in, Gaughan says, with companies trading at a diversification discount (also called the conglomerate discount). Say, for instance, a business has 10 separate divisions, and each division is valued at $1 billion. A diversification discount would be if the market valued the combined business at less than $10 billion – and this discount can be as high as 15 percent, according to Gaughan.

I ask Gaughan about the patterns that emerge from the worst deals. He cites two. First, bad deals often had "empire building" CEOs driving them, and second, the companies' corporate governance structures failed to rein these CEOs in.

As their name suggests, "empire builders" tended to pursue deals for flawed reasons, like enhancing their personal reputation or meeting lucrative performance targets. And they could push bad deals through, according to Gaughan, because they weren't held in check by their boards. What went wrong? Some boards had independent directors who "weren't necessarily all that independent." Others had directors sitting on three or four boards simultaneously, too busy and distracted to do the job for which they were hired. The good news, Gaughan says, is that we're seeing companies make "meaningful progress" in strengthening their governance structures and improving their practices – "though not always voluntarily," he adds.

The rebuttals directed toward academics in most fields can certainly be directed toward Gaughan. It's murky territory figuring out exactly what past deals can tell us about the promise of future ones, given how drastically businesses and the climates in which they operate have changed. Lessons often only crystallize with hindsight. Crucial factors can also get lost in large, quantitative studies. How to account for the deals that floundered because of factors beyond a CEO or board's control?

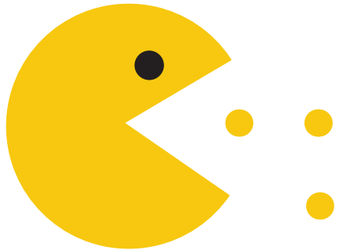
Throughout, Dr Gaughan tacitly acknowledges these limitations by using phrases like "tends to happen" or "almost always." Among research's most valuable use, he suggests, is looking at dealmaking conventional wisdom and seeing if the numbers actually back it up. The research doesn't have to make the decision, but it should inform it.

Perhaps the harshest reception to *Mergers, Acquisitions, and Corporate Restructurings* came from – and I'm being serious – "Gossip Girl," a TV show that describes its plot as "revolving around the fictional lives of upper-class adolescents living in Manhattan." It ran from 2007 to 2012 and was wildly popular among teenagers.

"Someone sent me the episode, and in it, one girl is talking to another girl," Gaughan says, betraying himself as less than a devoted "Gossip Girl" viewer. "And she's saying how much she likes this guy she's going out with. But this guy, he's kind of a nerd. And she picks up my book and it's sort of like, 'Who would sit and read *Mergers and Acquisitions* on a Friday evening?'"

This, I tell Dr. Gaughan, is the M&A story he should use at his next dinner party.

THE PAC-MAN DEFENSE



IN THE POPULAR VIDEO GAME from the 1980s, a player uses a joystick to move Mr (or, in later versions, Ms) Pac-Man, gobbling up points and trying to eat colorful ghosts drifting around the screen – while also avoiding being eaten by the ghosts themselves.

As the game was becoming popular, US companies started mimicking Pac-Man's eat-or-be-eaten game play in their increasingly extreme attempts to ward off hostile takeovers.

In *Mergers, Acquisitions, and Corporate Restructurings*, Dr Patrick Gaughan defines the Pac-Man defense as: "When the target makes an offer to buy the raider in response to the raider's bid for the target. Because of its extreme nature, this defense is considered a 'doomsday machine.'"

In other words, employing the defense means you buy the company that's trying to buy you.

The tactic first appeared in 1982. Bendix, a manufacturing and engineering company based in Michigan, offered $1.5 billion for 45 percent of Martin Marietta, an aerospace company it already owned 5 percent of. Martin Marietta rejected the bid, then made a counteroffer to buy slightly more than 50 percent of Bendix's stock. Bendix rejected that.

Both companies escalated the fight, which is where it became complicated. At some point, Bendix purchased 70 percent of Martin Marietta's shares, but Martin Marietta's management used the lapse between Bendix purchasing the shares and actually owning them to try and launch their own hostile takeover.

Two other companies joined the fight – Marietta enlisted the help of Connecticut-based United Technologies to make a separate bid for Bendix; Bendix called on Allied Corporation to be a white knight, and buy it instead of Bendix or United Technologies.

State laws, corporate charter rules, and multi-tiered offers all came into play. Courts were involved. Joseph H. Young, a Federal District Judge, said after reviewing the companies' ruthless back-and-forth, "I suspect Shakespeare had something like this case in mind when he said, 'a pox on both your houses.'"

From start to finish, the battle lasted less than a month. Marietta's defense was technically successful – Bendix didn't buy them. But their independence carried a steep price tag, as the company had quadrupled its debt to finance all of its share purchases and initiatives.

7 WAVES

Modern M&A began at the turn of the 20th century, with titans like Carnegie, Morgan, and Rockefeller consolidating and expanding their empires. Dealmaking has since gone through a series of "waves," often mirroring the ebbs and flows of global capital markets.

1st: 1897—1904

The inaugural wave of modern M&A created large monopolies in oil, mining, railroad, and steel in the US. It also saw the first billion-dollar mega-deal when J.P. Morgan's US Steel purchased Carnegie Steel. The resulting steel giant merged with almost 800 separate firms, and at its peak, accounted for as much as 75 percent of the US's steel-making capacity. Strong antitrust legislation followed in the US.

2nd: 1916—1929

An economic boom continued for almost a decade after the end of World War I, one that saw another wave of consolidation. Instead of merging for monopolies, companies merged to form oligopolies. A number of iconic US companies were formed during this second wave: General Motors, IBM, and John Deere. The second wave came to an abrupt halt with the stock market crash of 1929 and the Great Depression that followed.

3rd: 1965—1969

This brief wave saw US companies embrace the idea of conglomeration. This was the era that gave birth to IT&T, which acquired more than 300 companies during the 1960s; LTV, which went bankrupt in 2000, and Teledyne, the US industrial conglomerate. Research suggests that 6,000 mergers happened during these four years, and more than 25,000 companies disappeared as a result.

4th: 1981—1989

The legendary era of corporate raiders and poison pills, hostile takeovers and leveraged buyouts, the fourth M&A wave saw takeover strategies become much more contentious and sophisticated. M&A activity also spread to Europe, and cross-border mergers became more common across the continent.

5th: 1993—2000

The first truly international merger wave, Germany, the UK, France, Canada and Japan all saw sharp increases in the total dollar value of M&A. The largest deal of this wave – and arguably still the largest merger in history – saw UK-based Vodafone purchase Germany-based Mannesmann in 1999 for $180 billion. Runner up: Pfizer bought fellow pharma business Warner-Lambert for $90 billion.

6th: 2003—2008

Dealmaking picked up after markets had recovered from the dotcom bubble. Activists were at the helm, playing an important role in the M&A resurgence. The peak of the sixth wave was 2007, a year that saw an estimated $3.6 trillion in global M&A activity, according to Acuris. The wave crashed with the subprime mortgage crisis in the US and the ensuing financial crisis.

7th: 2011—today

Recovering equity markets coupled with increased private equity activity helped spark a return of M&A in 2011. In 2013, M&A activity increased in every quarter. In 2015, Acuris estimated global M&A activity to be $4.28 trillion – surpassing the previous record year of 2007. The wave continues today, with both 2016 and 2017 surpassing $3 trillion in total M&A value worldwide.