Geoff Meeks and J. Gay Meeks

The Merger Mystery

Why Spend Ever More on Mergers When So Many Fail?

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10. Feedback Loops

> Growth through continued acquisition is like a drug. The more successful each deal is, the bigger the next deal has to be to make an impact and continue the pattern of growth. The take-over vehicles not only found that bigger and bigger take-overs were necessary to maintain profits growth, but also found a series of techniques associated with acquisitions and disposals which could be used to boost profits. (Smith 1996, p. 19)

An extraordinarily frank account of such a circular and cumulative feedback model of serial acquisition was provided in Lynch (1971) by a CEO who deployed it many decades ago. He quotes the CEO of Contek (not its real name):

> Obviously, the one reason that we can justify this kind of an investment is the high price-earnings ratio placed on Contek by the market, which reflects continued confidence in our growth program [...] Because of our high multiple and because of the relative size of our respective operations, this projected earnings [of the target] will strongly enhance our market value. This in turn will make it possible for us to raise additional capital to acquire other companies and generally to fulfil the growth which is expected of us.
>
> An interesting consequence of the transaction is the fact that this projected earnings [of the target] added to current earnings alone would raise total earnings per share from $0.61 to $1.0. At our current [price-earnings] multiple, the effect would be to raise our stock price to $30 per share from its current value of $18.

Contek made fifteen acquisitions in a six-year period studied by Lynch. Sales rose thirty-six-fold. 93% of the sales at the end of the period came from the newly acquired subsidiaries. Searching for operating gains, Lynch analysed the accounting profits (net, before tax) on the book value of total capital for Contek subsidiaries: he found either 'no improvement or declines on either a simple or weighted average basis'.

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And yet earnings per share—the performance measure still prominent in companies' annual reports, press and analyst commentaries, and executive bonus contracts—increased from 15 cents to $2.30.

Gryta and Mann (2020) in their study of the rise and decline of the US giant GE drew attention to a similar potential 'virtuous' circle in merger activity. They note that the 'all important' (p. 48) performance metric followed by Wall Street was earnings per share (EPS—in Chapter 2 we noted its role in performance-related pay contracts for senior executives). And they go on to explore the powerful role of M&A in boosting earnings per share, whether or not the acquisitions succeeded in securing operating gains:

> A steady stream of acquisitions fed the earnings momentum. GE could use its unusually high price-to-earnings ratio [PE] for an industrial company as high value currency to pay for deals. By acquiring companies with a lower price-to-earnings ratio, GE was getting an automatic earnings boost.
>
> As an example, if GE was trading at a price-to-earnings ratio of 40, that meant that, if its stock was $40, it was earning $1 per share every year. If GE then bought a company with a price-to-earnings ratio of 10—that company was earning $4… for every $40 of stock…

In relation to our question of why firms can get away with mergers that fail, Gryta and Mann's arithmetic means then that there could be a gain in earnings per share even if the deal led to a decline in the target's operating profits.

Gryta and Mann go on:

> GE shares weren't going to stay valued that way forever. It would have to do more deals or use other methods to produce earnings. One way to do this was by contorting accounting rules to make acquisitions seem even more profitable. (p. 50)

GE certainly 'did more deals': almost 1,000 acquisitions in the two-decade tenure of CEO Welch (Gryta and Mann), some 700 in the sixteen-year tenure of his successor Immelt. And Gryta and Mann recount the creative accounting devices they deployed to manage earnings (all familiar from Chapter 9's cookbook): tweaking the expected future costs of multi-period contracts (p. 7); fudging the value of inventory (p. 29); channel stuffing (p. 31, p. 91); writing down the 'fair value' of acquired assets (p. 50).

Many of the 1700 businesses bought by Messrs Welch and Immelt were subsequently sold off. By 2018, GE's market value was a small fraction of its level at the millennium, and—having been the longest surviving member—GE was removed from the Dow Jones Industrial Average (Dissanaike et al. 2022). And in 2021, CEO Larry Culp announced that what remained of the company was to be broken up (Edgecliffe-Johnson et al. 2021)

An extreme example of the feedback model of serial acquisition combined with creative accounting is provided by the British company Coloroll, analysed by Smith (1996). In the five years from its listing on the stock market in 1985 with a market value of £37 million Coloroll acquired fifteen companies at a cost of £400 million, one of those acquirees having itself made twenty-five acquisitions in the preceding four years.

Coloroll made aggressive use of the devices we outlined in the previous chapter. In particular it used acquisitions to create a cookie jar: the inventories and receivables of targets were written down, and restructuring provisions were created, artificially boosting reported profits following the acquisitions, creating favourable conditions for financing and securing further deals. In its final year, £52 million of 'profit' were drawn from the cookie jar—expenses were debited to the provisions account rather than to the profit and loss account, effectively swelling reported profit by that amount. Total reported profit for the year was £56 million. Had it not been for the provisions the management used, reported profit would have been just £4 million. Such examples prompted strong action by the Accounting Standards Board to curtail such use of restructuring provisions (Tweedie, Cook and Whittington forthcoming).

Apparently highly profitable according to the recent accounts, but heavily indebted, illiquid and in reality insolvent, Coloroll failed a few months later.

However, the ingenious architect of Coloroll's rise, Managing Director Philip Green, was not permanently lost to UK business. He plays an important role in the next chapter.