Mergers in the Food Industries:

by John M. Connor and Frederick E. Geithman

After a hiatus of less than a decade, American industry is in the throes of its fourth bout of mergermania. Mergers have affected all off-farm stages of the food and fiber system.

Food and tobacco manufacturing firms have been major players in the recent wave of mergers (Figure 1). The number of large food and tobacco processors acquired by other companies averaged no more than six per year through the early 1960s. But the number acquired per year doubled in the conglomerate merger wave of the late 1960s. It surged again after 1975 to 16 per year in the late 1970s and 38 per year in the early 1980s.

The dollar value of book assets acquired by the large food and tobacco processors follows a trend similar to company numbers. It reached a 5-year average of $6 billion in the first half of the 1980s--nearly 4 percent of the total value of the assets in all food and tobacco processing companies. And, this average excludes leveraged buyouts like the mammoth 1985 buyout of Beatrice Foods for $5,362 million. Incomplete data for 1986 suggest that food industry mergers in that year exceeded $8 billion.

Book asset values are affected by inflation. To adjust for inflation Figure 2 compares the book or market value (where available) of acquired firms with the book value of all food and tobacco manufacturers in the same year. By this standard, the record size of 1977-1987 merger movement is not a money illusion. Despite undercounting inherent in the series, the proportion of all available food and tobacco manufacturers' assets that were acquired clearly peaks in the late 1960s at 2.6 percent per year and the early 1980s at about 3.5 percent per year.

Grocery Retailing

Comparable merger data for other stages of the food system are available only for grocery retailing. Until 1977 there was no significant trend in the combined sales of acquired food retailers except for a slight rise in 1965-1969 (Figure 3). However, there was a noticeable burst of merger activity after 1976, as measured by both current and deflated company sales figures of the firms acquired. The 1975-1979 period is strongly affected by the 1979 takeover of A&P, a $5,558 million company, by Tengleman, AG. In two years, 1979 and 1984, the sales of acquired food retailers exceeded $9 billion, or 4.8 percent and 3.5 percent of total industry sales, respectively.

Some Corporate Families

Mergers and acquisitions often leave the names of acquired subsidiaries unchanged. Food labels and advertising usually do not reveal parent company names. That means that most of us do not know whether any one "company" is owned by another or if it owns other companies.

For SEC-regulated firms, the information is a matter of public record. For example, Phillip Morris owns General Foods, which in turn acquired Oscar Mayer, which owns Louis Rich (turkey products). Ralston Purina's animal feeds business was purchased by British Petroleum (the leading producer of feeds in Europe), and Occidental Petroleum owns Iowa Beef Processors. Unilever, the world's largest grocery products company, acquired Chesebrough-Pond's, maker of Ragu spaghetti sauces. Kentucky Fried Chicken was sold to Pepsico after having been previously acquired by R.J. Reynolds. Burpee Seeds is owned by ITT Corporation.

Motives and Effects of Mergers

There is a long history of debate as to whether society is helped or hurt by mergers and acquisitions. Even the strongest critics of mergers concede that mergers among companies of certain sizes or financed in some ways are valuable to the economy, whereas merger advocates admit that many mergers turn out to be mistakes.

MOTIVES. Explanations supportive of mergers emphasize efficiency. Large or multiproduct firms can take advantage of economies of procurement, production, and distribution not available to smaller, more specialized firms. Diversification reduces fluctuations in profits for the merged companies, and more stable profits enhance access to capital markets. Superior management replaces less efficient management, it is argued.

On the other hand, non-efficiency explanations suggest that mergers can confer market power on firms; that is, higher profits are related to exploiting input suppliers or monopolisti-

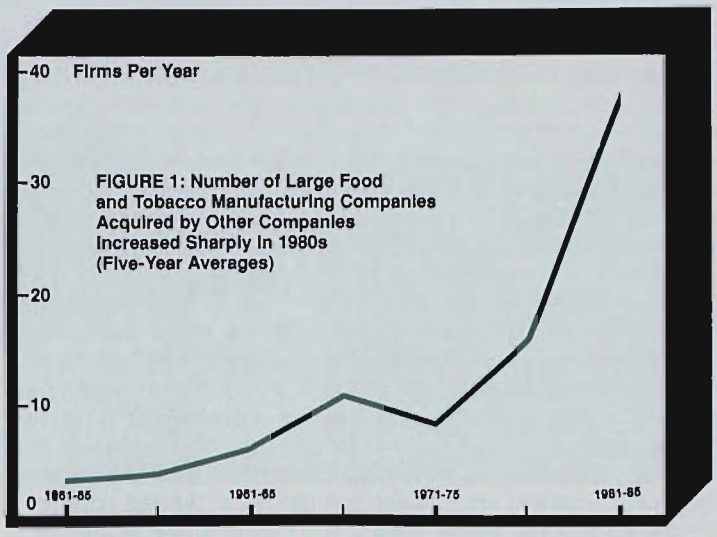

FIGURE 1: Number of Large Food and Tobacco Manufacturing Companies Acquired by Other Companies Increased Sharply in 1980s (Five-Year Averages)

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cally higher product prices. Horizontal mergers eliminate other sellers in the same market. Moreover, such mergers, notably in the meatpacking industry, have severely restricted selling alternatives in the market for fed cattle and other farm products. Examples abound of enhanced procurement power of processors after product extension mergers. Multiproduct grocery manufacturers have more clout in the battle for retail shelf position. In addition to market power explanation, empire-building and prestige of sheer size have motivated many mergers.

EFFECTS. Most empirical research seems to show that mergers do not on average result in any measurable efficiency gains for the merged firms. Based on broad samples that include food firms, these studies show that post-merger profits or market values do not rise relative to the pre-merger period. Moreover, for most kinds of mergers, post-merger market shares decline significantly relative to pre-merger levels.

These findings, if true, suggest that mergers result only in income transfers. Income is transferred from the owners of acquiring firms to the owners of acquired firms. Another set of studies show that managers of acquiring firms, in the excitement of the chase, err too high in calculating the value of the target firms. Moreover, managers of target companies often lose their jobs or incur cuts in salaries, while the positions of managers of the acquiring firm tend to be enhanced by the mergers.

Thus, it should not be surprising to us that the business press is replete with examples of merger mistakes from the viewpoint of the stockholders of the acquiring company. Examples of managerial "hubris" (the conviction that individuals can consistently out-guess and out-perform the market) or empire-building by managers of acquiring firms are pervasive.

It is difficult to pin down precise estimates of the effect of mergers on efficiency and consumer prices. Nonetheless, there are some obvious effects of mergers. One, of course, is the massive restructuring of markets due to mergers. Markets are becoming more concentrated on the selling side, and farmers must contend with greater bargaining power when they sell to processors.

Another obvious effect is on the size and growth of different firms. The lesson for the managers of food manufacturing firms seems to be that merging is necessary for growth and maintenance of leading market positions. There is evidence that over *half* of the sales of the 100 leading food manufacturers were provided by units acquired since 1950.

Another major impact relates to firm diversification. Conglomerate firms have available to them several forms of oligopolistic conduct not open to single-line firms. They can, for example, use their deep pockets in one profitable line to subsidize losses due to predatory tactics in another line. In addition, there are significant information losses for investors and potential market entrants. Diversified companies can easily hide extreme performance outcomes in their financial statements, and this loss of information increases the risk of entry for potential rivals.

Another widespread concern is the defensive behavior that many firms utilize to avoid being acquired. Not only are valuable corporate resources being frittered away on "poison pills," "golden parachutes," and other costly merger defenses strategies, but many firms acquire other firms simply to avoid being acquired by still other firms. Such actions add significantly to the burgeoning pool of corporate debt in the United States.

Finally, mergers have had significant adverse effects on national productivity growth. Perhaps the most carefully crafted study of the efficiency impacts of mergers is the recent book by Ravenscraft and Scherer. Utilizing exceptionally detailed information on hundreds of mergers in the manufacturing sector between 1962 and 1976 (most of them of the conglomerate type), they found that economic performance declined for three out of five types of mergers. Pure conglom-

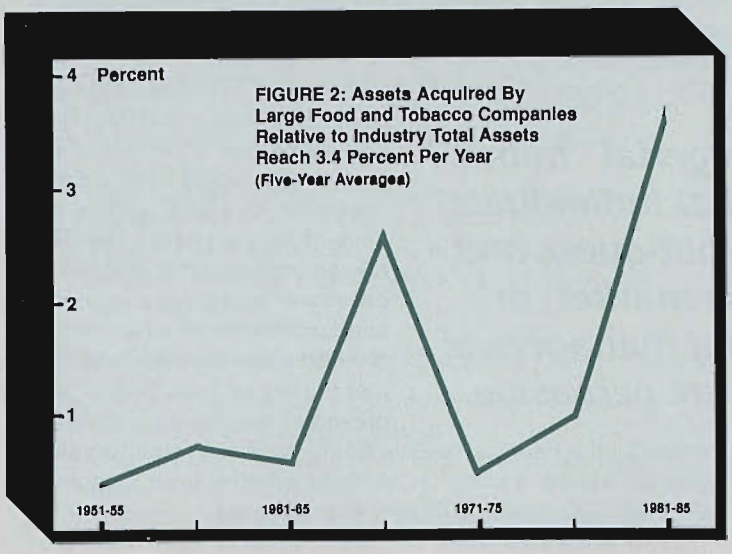


FIGURE 2: Assets Acquired By Large Food and Tobacco Companies Relative to Industry Total Assets Reach 3.4 Percent Per Year (Five-Year Averages)

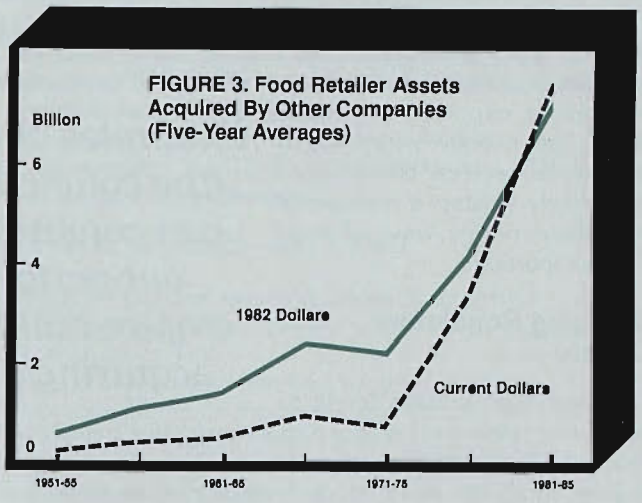


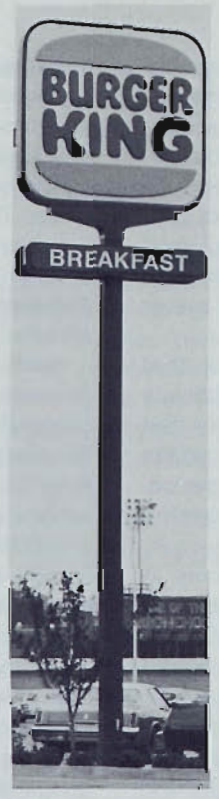
FIGURE 3. Food Retailer Assets Acquired By Other Companies (Five-Year Averages)

erate mergers were the least successful type, while on average "mergers of equals" exhibited improved post-merger performance; horizontal mergers and acquisitions effected through tender offers were at best neutral. For all types of mergers, net efficiency losses in the manufacturing sector alone were estimated to be in the range of $2.4 billion to $3.3 billion per year in 1976, or 0.6 percent to 0.8 percent of U.S. GNP. The efficiency losses induced by merger explained one-tenth of the slowdown in productivity growth in manufacturing during the 1970s. Moreover, R&D outlays by acquired units were significantly reduced following merger, causing a further drop in subsequent productivity growth.

National Merger Policy

One reason for the latest wave of mergers has been a laissez-faire policy in Washington toward the "market for corporate control." The lack of consensus on an appropriate legal theory has left regulators ill-equipped to slow conglomerate mergers. Moreover, the economic philosophy of key policymakers appointed after 1980 led to lax enforcement of the nation's antitrust laws, giving the green light to corporate marriages. Merger challenges in the 1981-84 years were at their lowest levels in the post-World War II era. Only 12.5 percent of all large food manufacturing mergers were challenged, well under half the historical rate. From 1982 to 1986 only 0.7 percent of all reported mergers were subject to federal enforcement actions.

But the policy approach of the 1980s in a sense was only the logical outcome of developments beginning in the 1960s. Several promising legal theories challenging conglomerate mergers were tested in the courts in the 1960s, but the changed composition of the Supreme Court in the early 1970s thwarted further legal experimentation. In addition, the abandonment of several merger guidelines (such as the ones for grocery retailing in 1967 and grocery products manufacturing in 1968) and the loosening of strict market-share standards of merger enforcement made it more difficult to challenge proposed mergers.



The Burger King chain owned by the Pillsbury Company is an example of diversification by food processors in the late 1970s.

The most disturbing aspect of growing industrial conglomeration is that there does not appear to be any market-driven limits or countervailing economic forces. Mergers appear to breed on themselves, hermaphrodite-like. Stock market crashes quash giddy speculation, but at great social cost, and the pause seems to last for only five or ten years. The new federal tax code is expected to reduce slightly the incentives for merger. But, by themselves, these forces are unlikely to stop a resurgence of another merger wave of even larger proportions.

Changing Regulatory Climate

Several events seem likely to shift public opinion in favor of a more restrictive merger policy. National TV carried pictures of multimillionaire merger arbitrageurs being led away in handcuffs for using illegal insider trading information. A number of Hollywood movies deride Wall Street's former golden boys. The states' attorneys-general have appealed to Congress and to the Justice Department to stop or slow the pace of mergers. Opinion polls seem to indicate that voters feel that deregulation in several areas has gone too far.

Several small changes have already placed greater constraints on mergers. The IRS initiated changes in tax rules that will increase the taxability of mergers. The Federal Reserve Board issued new regulations that attempt to outlaw "junk bonds," a new financial instrument at the heart of many recent mergers. Congress, which is supposed to legislate such major changes, did not challenge the new regulations. Instead, members surprisingly heaped praise on the Fed and the IRS.

In July 1987, a new rule promulgated by the Federal Trade Commission significantly tightened merger pre-notification procedures under the Hart-Scott-Rodino Act. Now many investment partnerships must report stockholdings of $15 million or more that were acquired with an intent to take over a company. Perhaps more significantly, potential bidders must undergo a 15 to 30-day merger review by the FTC before purchasing more stock--an action that reduces the element of surprise in hostile takeovers. A most interesting development was the 1987 U.S. Supreme Court ruling that upheld an Indiana merger law that delayed voting rights for shares held by corporate raiders. State merger law had previously been viewed as toothless.

Some Likely Merger Restrictions

It is likely that new Federal merger laws will be passed in the next few years, many of them with the support of business leaders who feel unduly harassed by takeover attempts. The 1986 Reagan administration proposal to relax the merger provisions of the Clayton Act is opposed by most mainstream economists and is unlikely to be passed by Congress. The most likely kind of bill to be passed is one sponsored by Senator Metzenbaum of the Senate Judiciary Committee that would extend the period of antitrust review from 20 to 60 days and would require partnerships to submit pre-merger notifications under the Hart-Scott-Rodino law. This approach is no panacea, however, as some observers believe that pre-merger negotiations may actually facilitate mergers.

Other changes are likely to affect SEC notification procedures. Presently, partnerships can obtain over 5 percent of the shares of a target firm without informing the SEC within ten days of the purchase. The SEC rule on notification is likely to be adjusted to require quicker announcements of small blocks of shares. Devices to limit further the use of "junk bonds" and greenmail are likely to be implemented by the Federal Reserve Board or SEC. A statutory definition of "insider trading" is likely to emerge from Congress, giving the SEC greater authority to prosecute.

Bills to restrict all large corporate mergers have been pro-

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posed several times in the last few years though prospects for passage are unclear at this time. Because claims of the efficiency of mergers rest on thin evidence, the key feature of these laws may be to place the burden of proof on all would-be merger partners above a certain size. The law now requires public officials to prove that a proposed merger might create market power, and that is a heavy burden to bear. Finally, although observers are skeptical of the ability of the financial

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"community" to reform itself, there remains the possibility of private-sector initiatives to introduce a greater degree of fairness and objective rationality into the rules of the merger game. For example, the recent takeover bid by the Shearson Lehman investment firm for a company that it had advised was nearly universally condemned as unethical. There is an evolving consensus that boards of directors ought to be more autonomous from management. The time seems ripe for a renewed emphasis on the primacy of stockholder welfare in managerial decisionmaking.

But in the end, history suggests that many of these steps will not be taken. And even if they are, the pace of merger activity will at most be slowed, not halted.

For More Information

See *Mergers, Sell-Offs, and Economic Efficiency* by David J. Ravenscraft and F. M. Scherer, published in 1987 by The Brookings Institution for more details and for discussion of the effect of mergers on efficiency of our economy. The address is 1775 Massachusetts Avenue, NW., Washington, DC 20036. The price is $12.95 (paper) and $32.95 (hard cover).

One of Cargill's newly acquired soybean processing plants. Photos Courtesy Photographic Services Department, Purdue University.

THE FOUR GREAT U.S. MERGER MOVEMENTS

The First Movement—1897–1906

- Some 3,400 mergers of manufacturing and mining companies were consummated.
- The world's first industrial "trusts" were created.
- Monopolies with forward and backward vertical linkages were developed.
- Large single product firms—American Tobacco, General Mills, and Swift—were created in this period.
- Sherman Act (1890), first effectively enforced during Theodore Roosevelt administration, was enacted in response.
- Standard Oil and American Tobacco were forced to divest in 1911.
- Meat Packers signed a decree in 1920 agreeing to sell their interests in cattle yards, meat warehouses, and meat stores.

The Second Movement—1925-1930

- Some 5,400 mergers of manufacturing and mining companies were accomplished.
- Over 14,000 utilities, banks, and retail stores were acquired by other firms.
- Section 7 of Clayton Act (1914) that prohibited acquisitions whose effect "may be substantially to lessen competition, or to tend to create monopoly" was circumscribed through interpretation that it did not apply to mergers effected through purchase of assets rather than stock.
- Multiproduct food companies—General Foods and Standard Brands—were pieced together.

The Third Movement—1960-1970

- Twenty-six thousand mergers, with over half in mining and manufacturing, took place.
- Food manufacturing firms were absorbed into conglomerates like ITT (Continental Baking), LTV (Wilson Foods), and SCM (Durkee's).

The Fourth Movement—1977-1987

- About $400 billion spent on industrial mergers.
- Leveraged buyouts, unfriendly takeovers, and greenmail became prominent.
- Foreign investments played a prominent role.
- Many conglomerate food firms sold off unrelated businesses to focus on fewer lines.
- Federal antitrust agencies relaxed merger enforcement after 1980.