Appendix 1.1

That M&A Tax Scare Rattling the Markets

By Edward Yardeni
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Tomorrow the House will vote on a $12 billion tax increase containing what was a major cause of the recent stock-market crash. That is a provision designed to severely limit corporate merger and acquisition activity.

Many investors and traders learned of this plan from a Wall Street Journal story on Oct. 14. The day before, the Democrats on the House Ways and Means Committee agreed on a number of tax-raising measures including the elimination of the deduction for interest expenses exceeding $5 million a year on debt from a takeover or leveraged buyout.

On Oct. 15, the full committee approved the package. Takeover stocks were pummeled late during the trading day (see table). Several announced and unannounced deals were delayed. Arbitragers sold large blocks of the stocks.

Though the tax measure faced an uncertain future both in Congress and with the White House (the Senate Finance Committee on Oct. 16 approved a bill without the anti-takeover provisions), the arbs sold fast. They are not long-term investors, and they feared the worst.

Under the Ways and Means proposal, the interest provision would be retroactive to Oct. 13, a crushing setback to any deal being worked on or considered. To understand its effect, consider this case:

For an $800 million business in a stable industry, a relatively conservative acquisition financing would be 75% debt and 25% equity. The annual interest charges on the $600 million debt would be about $60 million, assuming a 10% interest rate. Under the committee’s plan, only $5 million would be deductible. So additional taxes of $18.7 million (34% of $55 million) would have to be paid every year.

The acquirer’s annual after-tax cash flow would be reduced by $18.7 million, lowering the value of the business by an estimated $187 million, the value of the reduced cash flow assuming a 10% discount rate. That’s a 23% decline in the value of the business!

The decrease in value would be greater if the acquisition were financed entirely with debt, which would be possible if a larger company were the acquirer. It would be less dramatic if more equity were used in the takeover.

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How could the collapse in the prices of a small number of takeover stocks cause the awesome crash in the entire stock market? Corporations were the largest purchasers of stocks during the bull market. According to Federal Reserve Board data, corporate equity outstanding declined by $74.5 billion during 1984, $81.5 billion during 1985 and $80.8 billion during 1986. Acquisitions and stock repurchases account for this dramatic reduction in the supply of stocks.

This suggests that the bull market was largely fueled by mergers, acquisitions and buy-backs. Stock values were driven up by corporate entrepreneurs willing to pay above-market prices to control other corporations. Controlling ownership must always be worth more than minority ownership. Presumably, the new owners believe that they can increase the value of the acquired company above their purchase price with better management and by restructuring the business, including selling undervalued assets.

The recent surge in mergers and acquisitions brought more, and larger, publicly traded businesses into the category or corporations that could be acquired. So price earnings ratios rose closer to valuations based on majority rather than minority, ownership. Owners of minority interests in public companies benefited as share prices rose.

As shown, the value of a typical corporation to a potential acquirer would be cut by roughly a quarter under the Ways and Means plan. Interestingly, the Dow fell 20.6%, from Oct. 13, when the idea was accepted, through last Friday. Price-earnings ratios collapsed toward minority ownership levels.

Apparently, the House Ways and Means Committee adopted the provision not only to raise taxes, but also to halt mergers and acquisitions. Whether this is a good idea is a profound policy question with tremendous implications for U.S. productivity and trade competitiveness. However, a better way to slow takeover activity is to have stock prices that as fully as possible reflect the control values of businesses. Share prices would be higher and pension funds, mutual funds and individual share holders would be, in the aggregate, $1 trillion better off, or about where they were before the October massacre.

In these days of a weakened presidency, the threat of the Ways and Means bill being enacted was sufficient to cause a wide-spread flight from equities. We've seen recent precedents for financial-market panic in response to Washington.

For example, on March 27, the administration announced a tariff on certain imports of Japanese electronic products. The dollar immediately plunged and government bond yields soared from 7 ½% to 9% in a few weeks. Early this summer, the Treasury proposed termination of a tax treaty with the Netherlands Antilles, which permits certain investors to avoid withholding on bond-coupon income. The market in affected bonds declined precipitously until the Treasury corrected the admitted error.

A curious aspect of the present anti-takeover initiative is that foreigners would not be adversely affected by taxes. Their relative ability to acquire U.S. owned companies would be enhanced, doubly so because U.S. companies would stand to be sold at a significant discount to their potential value.

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The Ways and Means measure contains some needed takeover reforms such as a prohibitive tax on “greenmail” payment to raiders. But putting most companies out of reach of entrepreneurs, and sacrificing a measure of the more-accountable management that this fosters, has already had a disastrous effect on equity prices, aggregate wealth and national income. If the House puts the anti-takeover plan to rest, perhaps some of the damage can be undone.

How Some Takeover Stocks Were Hit

	Tues 10/13	Wed 10/14	Thurs 10/15	Fri 10/16	Mon 10/19
Allegis	103 3/8	102 1/4	97	93 7/8	66
Dayton Hudson	54 1/2	52 7/8	49 1/2	44 3/4	30
Gillette	41 1/4	40 1/2	36 5/8	32 3/4	24
Irving Bank	74 1/2	72	70	65 3/8	48 1/2
Kansas City Southern	70 1/2	67 7/8	61 3/4	56 1/2	45
Mead	45 1/4	43 1/4	41 1/2	38 3/4	29 1/4
Santa Fe Southern	60 3/4	61	56 1/4	51	41 3/8
Tenneco	59	60 1/4	57 1/2	55	43 1/4
USG	53 5/8	52 3/4	49 1/8	43 3/8	31 1/2
Zayre	31	30	28 3/8	24 3/4	15 5/8

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