Merger Madness: Dark Days in the Drug Industry
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I always get concerned when I hear executives, analysts, and business journalists talking about how they have to get bigger in order to survive. On March 10, 2009, the *Wall Street Journal*'s report on the just-announced proposed acquisition of Schering-Plough by Merck said, “What will be left is an industry dominated by behemoths, raising questions about the fates of smaller drug companies, as well as the countless small biotechs hungry for suitors.”

When will these people ever learn the lessons of history?

I have been fascinated by large corporations, their behavior and their leaders, for a long, long time. I started subscribing to Fortune magazine in 1963, when I was 12 years old. I started studying the stock market about the same time. In those many years, I have seen industry after industry decide they needed to “get bigger to compete.” The banks, the grocery chains, and many others.

When has this strategy really paid off?

Citigroup went around buying up brokerage houses and financial service entities left and right, and today it is a basket-case. Kroger, Safeway, American Stores and others thought the only way to compete with giant Walmart (which has made almost no important acquisitions) was to buy up other grocers. Yet today the most viable competitors to Walmart's powerful grocery business are strong, focused, independent regional companies like HEB of Texas and Publix in the Southeast.

Are Warner Brothers, Time, AOL, and Turner Broadcasting really better off by being part of one giant company? How often does the much-herald concept of “synergy” really pay off?

Don't misunderstand me – there are times when mergers do make sense, there are times when “rolling up an industry” by combining regional or other firms works to the benefit of customers, employees, and stockholders. Part of the growth of Whole Foods Market came this way, although they were also “organically” growing their original core business at the same time they were buying other companies. The same goes for Federated Department Stores, which balanced its Northeastern and Midwestern operations from the 1950s onward by buying up local Sunbelt leaders like Dallas' Sanger-Harris, Houston's Foley's, Miami's Burdine's, Atlanta's Rich's, and Los Angeles' Bullock's. During Federated's glory years of highest profitability, they left these companies alone and did almost no consolidation and cost-cutting. Instead, they focused on serving the customers in each individual market.

And I am not proposing that legislators and regulators try to prevent such mergers. My favorite college economics teacher, George Stigler, later won a Nobel Prize, largely for his skepticism about the power of regulation to improve anything – skepticism based on a lifetime of research and reason. If business leaders want to experiment with acquisitions in order to build their businesses, let them do it. If the owners of a company want to sell out and take their profit, let them do it. They may be doing the wrong thing in my judgment, but I have not seen any evidence that attorneys or bureaucrats working for the government have any better judgment. My observation over the years is that the regulators either do the bidding of the industry giants or they are behind the times, regulating the industry that was rather than the industry that will be.

And I certainly understand what it is like to do one of these deals. I was the "mergers and acquisition guy" at a big retailer in the late 1970s, and looked at about 400 acquisition candidates. We did one deal. That deal worked out well, and both created new jobs and made literally billions for our stockholders. Maybe we were just lucky, although I'd like to think we did that acquisition for all the right reasons – we believed we could really help this excellent, smaller company reach new markets and more quickly fulfill its promise.

When you are in the heat of one of these deals, it is very exciting. The process is top secret until it is announced (unless you are a friend of Martha Stewart's). The hours are long and the lights stay on late into the night. You begin to dream about all the great things that will result. By the time you finish composing the packages for the Board of Directors, listing out all the great reasons to do the deal, you believe them all. If you are the CEO, you feel like your whole reputation rides on the deal. You cannot live without it; you will be crushed if it falls through. You think it's the "deal of the century," a "transformational event" – the words used by Merck's CEO. You have drunk your own Kool-Aid.

All through this process you surround yourself with investment bankers and mergers and acquisition consultants, people who often have no purpose and little income if the world stops doing big deals. It is unlikely for them to advise against a deal, although I have seen it happen.

When I see these giant elephantine businesses mating, there is a lot of thunder and noise – headlines – but what really comes out of it? Some years ago, when H-P bought Compaq, the "megamerger" did nothing to help the combined company compete with the more entrepreneurial Dell. Integrating two big and different cultures just took their eye off the customer. Only after H-P got rid of the CEO who pulled off the deal and settled into a new mindset did its recovery begin.

When the giant banks merged, all that happened to customers was they went from being an 8 digit number to being a 12 digit number. Read the press releases that come out of giant mergers, and try to find any mention of how it will result in better products or better customer service. The usual line is more like that in the Journal article on the Schering-Plough-Merck deal, "the drug giants are looking to cut costs by combining research and sales efforts and eliminating over overlaps." In other words, how many people can we lay off? These are not the signs of a healthy, growing, future-directed business.

In all my years of studying big business, my one conclusion is that when an industry starts a merger wave like this – just a few weeks ago Pfizer announced they were buying fellow drug giant Wyeth for $68 billion – that is a sign that the industry has peaked and is on its way downhill.

Between 1980 and 2005, the great department store industry where I, like many others, learned retailing consolidated from about 6 major players down to 1 (Macy's). This was not emblematic of a great time in the industry, it was the sign of an industry in decline. With just one big player left, I think it likely that Macy's can now continue to survive for many years. But the other remnants of the industry – Dillard's, Bon Ton, and the like – are not likely to be long for this world. (I treat the upscale operations like Nordstrom, Neiman's, and Saks as a separate industry segment.) Macy's buying up all its major competitors was probably the right thing to happen in an industry that is now well past its peak, a wonderful peak which lasted from about 1890 into the 1960s or even 1970s.

But the pharmaceutical (and banking) industries are not post-peak industries. Any study of the aging baby boom in the US, Japan, and Europe indicates that drugs have a phenomenal future. Any look at the global rise of the middle class tells us that financial services should be one of the boom businesses of the next 30-50 years. These are industries that are, based on their fundamental economic natures, poised for the best years of their lives.

And yet they think the only way they can prosper is to devour each other, to go to the long, painful, and often unsuccessful agonies of integrating different cultures. They think that size matters, that size wins. Tell that to US Steel, tell that to IBM – *formerly* the world's largest computer hardware maker and the largest software company. Tell that to General Motors, tell that to Sears.

No, I will place my bets with Microsoft and Intel, Toyota and Walmart. How many megamergers did these companies have to do in order to get to the top of the heap? It is *focus* that wins, the love of the business you are in. Not size.

Even those great companies now see the "unbenefits" or size, the "diseconomies of scale." Because they are the biggest and most visible, Walmart bears the brunt of "anti-big-box" cries when relatively few take aim at Target or Home Depot. Toyota for the first time has had massive recalls and now asks for government help. At the same time, they need to be watching over their shoulder for tomorrow's potential leaders like Hyundai and Chery. It is a very tricky situation when a company is at the top of its lifecycle "arc," when past success can easily breed complacency and arrogance.

It is symptomatic of the problem when you read that the reason these big drug companies "must" buy each other is that "the pipeline is dry," that they have too few new drugs coming out of their R&D operations to replace the old drugs coming off patents and going generic. *I thought the whole idea of these companies was to be engines of invention and innovation.* For years we have been told that these companies deserved their exceptional returns on investment, and that we should pay high prices for new drugs, because of the wonderful research they do. The glory of drug discovery is indeed one of the great success stories of American enterprise. At least it used to be. If your engine won't start, the answer rarely lies in buying someone else's engine and putting it under the same management that could not start your own engine.

One does not have to sit in the board rooms of the Fortune 500 in order to hear this madness of "you have to be big to survive." I have been there when Wall Street and venture capital folks suggested that Whole Foods Market – then with under a dozen stores – sell out to another company to insure its survival. The same logic led to the sale of one of the companies I started, Hoover's. While I am happy that Hoover's ended up in the hands of a well-managed company, Dun & Bradstreet, I will probably go to my grave believing we could have built a larger and more successful company by going it alone.

I am confident that what I have experienced goes on in the board rooms of entrepreneurial enterprises all around the world on a daily basis. I am not saying these are easy decisions – if you have accepted "other people's money" in order to grow your business, you have a broader responsibility to earn a return on their investment. Sometimes the price offered for your company really is so high that it would be stupid, or risky, to pass it up. But when you are thinking about selling your company, be very, very skeptical when someone at the table says "We can't be successful going it alone. We need to sell out for the company to survive."

None of the truly great companies in world business came to that conclusion, and you can rest assured they also had such talk around the board table.

This "illness" is not a recent phenomenon. In his classic history of the rise of American big business titled *The Visible Hand*, the great business historian Alfred Chandler tells the story of the formation of Nabisco. The National Biscuit Company was created by merging numerous big biscuit and cracker bakers, at the height of the first great American merger movement – in 1898. Virtually every major industry in America was being consolidated into great "trusts" – which led to the "antitrust" reaction of the government. The idea of corporate chiefs and investment bankers was that you could end "destructive and wasteful competition" by combining all your competitors. Crackers and cookies were no different from steel and sugar.

Within four years, however, the management of Nabisco wrote to their shareholders to tell them that this strategy had not worked out well; they were henceforth going to focus on internal, organic growth. Turned inward, Nabisco focused on building great brands, an art they helped create. Their first mass marketed brand was "Uneeda" biscuits. Even today Oreo, Ritz, and their brethren are among the strongest brands in America.

Likewise, the great trusts found that buying up their competitors failed as a means to stop competition. If they abused their market power, making ineffective products or overcharging for them, it did not take long for someone else (domestic or foreign) to start a new company and burst their monopolistic bubble. Even the most powerful trust of them all, John D. Rockefeller's Standard Oil, found ready competitors like the Pews of Philadelphia (Sunoco), the Mellons of Pittsburgh (Gulf Oil), the Dutch and British (Royal Dutch Shell), and independents Phillips and the Texas Company (Texaco).

I find it really sad when industries that should be great and strong fall into this same trap that bigness is good in and of its own sake. Bigness within a given product category or region, or high market shares, can play a role in success. But combining two companies which cannot achieve greatness without the merger will not get them any closer to greatness. No real strength evolves. Combining two also-rans does not make a winner. Combining a winner with an also-ran does not make a stronger company.

Daimler thought buying Chrysler would be magic – even I thought that one might make some sense. We were all wrong. When industry leader Boeing bought the weaker McDonnell-Douglas, it just took Boeing's focus off the great business they had built, and took years to integrate the cultures. Only then did a European consortium, Airbus, pass up Boeing to become the biggest maker of airliners – a wrong that took years to set right.

Even when two great companies go together, often little is gained. Capital Cities- ABC was one of the best-run media companies. So was Disney. But their merger has resulted in little of real value, as far as I can see. Both companies were much stronger when, in the early 1950s, Walt Disney cut a deal with ABC's entrepreneurial CEO Leonard Goldenson that led to the creation of one of the longest-running TV shows, the World of Disney. But that show only came about because Disney worked the then-three big networks against each other. Relatively-tiny ABC needed recognition the most and reached to make the deal, to take a chance on Disney, which was only doing about $30 million in annual revenue back then. The money from that deal was key to financing Walt's other experiment, Disneyland, which the bankers would not touch. Today, when Disney and ABC are part of the same company, there is no such opportunity for

creative bartering, for offering a Disney show to CBS or NBC, or for ABC to cut a deal with Dreamworks animation. I suspect that the merger led to a loss in the power of these two great companies, not a gain in their power.

Maybe the Schering-Plough and Merck merger will turn out okay. I hope so, for the benefit of their millions of customers, their thousands of employees, and their stockholders. Both of these have in the past been fine, well-run, innovative companies. But it is a bad sign that the whole drug industry feels they have to gobble each other up in order to prosper. That strategy has rarely worked in the past, and it is just as unlikely to work today and in the future.