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Conversation with Bernard L Schwarty

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Nine years ago Saul P. Steinberg, then fresh from college, had a new idea in computer leasing. He parlayed that idea into Leasco Data Processing Equipment Corporation, a dynamic international organization whose merger plans are grabbing headlines in the major business press.

Here Bernard L. Schwartz, Chairman of Leasco's Executive Committee and Mr. Steinberg's confidant, discusses Leasco's fantastic growth and the philosophy behind its recent mergers with Touche Ross partner Philip H. Cohen. Mr. Cohen and Mr. Schwartz have been working with Leasco since it was small enough to be run from Mr. Steinberg's kitchen table.
COHEN:

Leasco began in 1961 with an initial capitalization of about $25,000 in cash. Today it is a company with assets of more than one billion dollars, stockholders' equity of more than $250 million, and has grown from a small income to approximately $44 million in the current year—after including capital gains from the insurance operation. How do you account for this phenomenal growth?

SCHWARTZ:

There are several things. First of all, we have the easy, almost cliché answer—hard work. Second, we had a concept as to where our company should be going. Although starting out in the computer leasing business, we are proceeding in the concept of a broad-based computer and financial services, problem-solving organization. It is with this concept in mind that we geared our external growth at Leasco.
COHEN:

But this growth was not all through computer leasing. You’ve been on a campaign to acquire companies. How do you relate that to your overall concept?

SCHWARTZ:

Of course, much of our growth did come through acquisitions and mergers, and it is important to note that in every case our acquisitions were happy ones in that we achieved some synergistic value. In other words, the companies did well, or they fit into a particular pattern; they filled a void of business activity that we felt we should be involved in.

In addition, it is important to emphasize that Leasco’s attitude toward acquisitions is a result of a “make or buy” decision. This decision is based upon intensive study of the industry, the competition, the potential candidates for acquisition in this industry, and all other pertinent information applicable to that particular transaction. We have a Corporate Development Department under our vice president of corporate planning, Mike Gibbs, which is constantly reviewing all our business functions and activities and identifying those business areas which are desirable and profitable extensions for our efforts. After it identifies an industry, it analyzes the entire group and the competitive standing of each of the major companies in that industry.

Having made a decision to expand in a particular direction, we then measure the feasibility of developing internally or acquiring. Some of the considerations that enter into that measurement are Leasco’s financial resources, human resources, the time factor in developing as against acquiring, the management depth and strength of available companies, and the availability of industry talent—and generally, the cost (including time) of each approach. Generally, we prefer to develop ourselves, but we will acquire when the “make or buy” decision indicates that “buy” is more desirable.

COHEN:

It seems to me you did not make any significant “buy” decisions until Documentation, Inc. in 1967. What attracted you to a software company—and why Documentation, Inc.?

SCHWARTZ:

Documentation, Inc. is more accurately described as an information technology company, rather than a software company. It had developed computer-based tech-
niques of information storage, retrieval and dissemination of data in printed form, microfiche and microfilm. As you pointed out, it was a departure from computer leasing, but it certainly fit in with our overall concept of developing a computer services organization.

We viewed the disciplines they had developed over many years to be an important base for the development of a total information capability, including computer timesharing. Documentation, Inc. was a mature company, profitable, had a high degree of professionalism, and enjoyed an excellent reputation in the field in which it had become a factor. Its attractions to us were obvious.

COHEN:

How about Reliance (Insurance Co.)? Why did Leasco, which was then a growing company but not a giant, decide that an insurance company was a company to acquire, when that industry is known for being static and conservative rather than growth-oriented?

SCHWARTZ:

First of all, we did not see anything inconsistent in combining an insurance company with a financial services and computer services business. Reliance Insurance Company was a particularly attractive company in the property and casualty field. Long before we considered Reliance in particular, we made a complete study of the property and casualty field. We were struck by the fact that this was an industry that lost money in its main operation, that is, its insurance operation, but made money in its investments.

The industry had created redundant capital (surplus monies that were not utilized in the functioning of its business), and many of the insurance companies were looking then to create insurance holding companies so these surplus funds could be used for better returns in areas outside the property and casualty industry. Many of them had expressed an interest in getting into the fields we had already identified as of interest to us. So it seemed a natural fit for Leasco to merge with a company that had adequate funds to be used in those areas of activity.

COHEN:

I can see where these fit into your concept, but I imagine you and Saul (Steinberg, Chairman of the Board) get a number of questions—especially during the Chemical Bank incident—about whether you are a conglomerate. How do you answer them?
SCHWARTZ:

The fact of the matter is we are not a conglomerate, if I understand what a conglomerate is. For example, if you were to bring us a candidate for acquisition that had great return on invested capital, terrific gross profit margins and margins on sales, good management, and continuity and stability—but made hub-caps—Leasco would not be interested. A conglomerate might be interested. We have a concept of what our company should be; unless a new activity can bring additional strengths and capabilities to our existing structure, we are not inclined to make acquisitions.

At one time we did consider the banking industry to be a natural extension of the financial services end of our business. Many banks are involved in the same business as Leasco, such as computer services, equipment leasing and insurance.

Of course, any decision to enter the banking field must take into careful consideration the proposed changes in legislation affecting bank mergers and non-banking activities for bank holding companies. Until the legislative picture is clarified, the banking industry is certainly not on a front burner for an extension of our financial services activities.

COHEN:

Your acquisition of Pergamon Press (Ltd. of London) has received considerable publicity in the newspapers, too. It has been a most on-again-off-again acquisition, and the outcome is still not settled.

SCHWARTZ:

It has been an interesting situation. In fact, it is a good argument for why fundamentals should be followed in an acquisition. As you know, we now own approximately 38% of the stock of Pergamon and we have had to delay our bid for the acquisition of the remainder of the stock. It became necessary for us to delay our tender offer for the remainder of the outstanding stock pending a determination of the actual earnings for 1968 and 1969.

As you know, Pergamon is a dominant factor in the publication of scientific books and journals. Its potential could only be maximized by developing capabilities that Leasco is expert in: computer and information techniques. Pergamon was uniquely positioned for the development of an international scientific data bank which would have an internal tie-in to our plans for timesharing. Accordingly, we had not only identified publishing as one of our main areas of interest for development, we had particularly focused upon Pergamon as a potential candidate for acquisition.

Saul Steinberg had met Robert Maxwell in London and had some very preliminary, exploratory discussions with him. In subsequent discussions we structured a deal with Maxwell whereby Leasco would tender for all the Pergamon outstanding shares; Maxwell agreed to support our bid and tender the stock that he owned and controlled (approximately 36%). As you remember, Pergamon is a public company listed on the London Stock Exchange; they in turn own 70% of an American company called Pergamon Press, Inc. The balance of the American company is owned by the public.

We have a specific and well-thought-out technique in making acquisitions. Whenever possible, we attempt to conduct a full investigation of the proposed company prior to entering into a contract. Of course, sometimes that is impossible when, for one reason or another, the other company refuses to make available its books and records prior to signing a contract. In those cases, we always investigate after signing the contract and before closing the transaction. Among other reasons, the purpose of the investigation is to verify the financial data on which valuations are based.

Another protection that we seek is for the management of the other company to warrant the accuracy and completeness of the financial data submitted to us during our negotiations.

Maxwell pointed out that the securing of warranties and the right to prior investigation was not normal procedure in making tender offers for public companies in England. However, we insisted on this protection and, as it turned out, it was fortunate that we did so.

Tender offers for public companies in England are quite a serious business, and it is not commonplace that—once an offer has been announced—that it be revoked. Having announced our offer, and during our investigation, we did take a position of purchasing 38% of the Pergamon stock in the open market. We had obtained the necessary clearance from the Bank of England to do so. We felt that the purchase of this stock was not an inordinate risk and would give us an important standing in the subsequent tender offer. Our judgment was based upon what appeared to be accurate financial information that was available. We had reviewed the certified statements of Pergamon for the last eight years, as well as examined the annual reports of both Pergamon Press, Ltd., and Pergamon Press, Inc. In addition, Pergamon and its investment bankers had made a forecast of the 1969 earnings. Incidentally, earnings fore-
casts are considered to be standard procedure for any company in preparation of a proxy statement because they are regarded seriously. The company’s investment banker and auditors usually pass judgment on the accounting principles on which the forecast is based. You may recall that in the latter part of 1968, Pergamon was involved in a well-publicized but unsuccessful bid for “News of the World” and, during that fight, it was generally regarded that all pertinent information regarding Pergamon had been fully reported in the news media. Accordingly, we felt that sufficient information was available for us to rely on. This information, of course, included the certified statements prepared by independent auditors.

However, serious doubts about the 1968 and 1969 earnings developed during the course of our examination. I might say, Phil, that my conversations with you and Eddie Heft (Touche Ross partner) in outlining the scope of our investigation, and the help your organization rendered during that time was extremely useful. Two of your people should be particularly singled out: Ian Irvine and Page Thibodeaux (partners in Europe), who went through some very trying times in attempting to secure the necessary information from a reticent Pergamon management. Just as an aside, it was necessary to rearrange working habits during this transaction; our negotiations generally started about 6 p.m. and hit a stride at about three in the morning.

At any rate, it became apparent that the reported earnings for 1968 and the 1969 forecast were considerably overstated. Consequently, our bid became over-valued. This and other considerations caused us to announce the revocation of our bid. At the current time, independent auditors are conducting an investigation of the 1968 and 1969 accounts. At the completion of their report, Leasco will prepare a bid for the outstanding stock, based on their findings.

COHEN:

Bernie, you are aware the Accounting Principles Board is considering potential amortization of goodwill, and is putting restrictions on the concept of pooling. How do you feel these will affect your acquisition program?

SCHWARTZ:

Well, I can’t say flatly that the accounting has no influence on our decisions as to whether we do a merger. It certainly has a very great influence on the form of a
merger. But in almost every case a merger or acquisition must stand on whether it’s a good business deal, and accounting is only a tool for putting the deal together. It would be a mistake, I think, for companies to make deals because financially—or accounting-wise—they get a short-term plus if the business deal is not a good one to support it long range. The most important consideration is for the transaction to make good business sense.

I have very strong feelings about the accountants’ attitude toward pooling. Although it is not a perfect tool, in some instances it is better than purchase accounting. My objection to the purchase concept is that it does not give the prudent investor as much information as pooling about what the company will look like after the merger. Further, to have the assets of the company inflated by an artificial number (goodwill), and then charge future earnings by the amortization of that artificial value, is not consistent with the economic realities.

COHEN:
Take a specific case, say Reliance. How do you think purchase or pooling would have affected that transaction?

SCHWARTZ:
As you know, we treated that acquisition as a pooling and such treatment was consistent with the general rules. We had acquired over 95% of the voting stock of Reliance through an exchange of our equity securities (voting preferred and warrants to purchase common stock). The management continuity of each company was shared and top executives of both companies served in the active management of each other’s offices as part of the executive structure and boards of directors. Although the question of pooling versus purchase accounting would have considerably affected the reporting results of the combined companies, the actual transaction was a consequence of business considerations and was achieved through active negotiation prior to the merger. These considerations included the taxability of the transaction, the dividend rate, and the no-call feature of the preferred stock and the term of the warrant. The result of the transaction afforded us the use of pooling so that the combined operations of the company would be consistent with the past reporting of Leasco and Reliance. In addition, the combined reports would be consistent with those of many other financial organizations.

I realize that questions have been raised with respect to the reporting of capital gains in the Reliance portfolio. However, this problem does not arise because of the pooling technique. It arises by virtue of an inconsistent policy of handling stock-investment portfolios by various financial organizations (insurance companies, banks, etc.). On balance, pooling presents a much more precise tool in presenting a fair picture of our combined operations.

COHEN:
Bernard, it is now five years since the start of your acquisition program; we all know nobody is 100 percent successful...

SCHWARTZ:
We have had more good scores than bad—a few we were interested in got away, but almost every acquisition has met the criteria we outlined prior to the transaction. The additional capabilities we obtained in the process, in most cases, would have been substantially more costly to develop by ourselves and have enabled us to grow into a major factor in the business activities in which we are engaged. Leasco is truly an international corporation with over 9,000 employees and over $1 billion in assets. So, on balance, I can say we have had a successful pattern.

In passing, Phil, I think it is appropriate to talk about another phase in any acquisition program, and that is the hard work after the negotiations are finished. Significant problems, depending upon the size of the acquisition, need to be solved in order to maximize the benefits for the combined companies. These problems have to do with organization, people relationships, questions of integrating similar functions, eliminating duplications, equalizing payroll incentive and fringe benefits, developing harmonious accounting—in short, reorganizing all the functions of running a business. We have found that the investment in people and effort in this phase is highly rewarding. It demands much hand-holding, understanding and operating skills. At Leasco we have developed a highly professional and well-motivated staff with expertise in the various areas of corporate activity. The effort has paid off in terms of creating a total corporate team with well-defined goals. In spite of the very active acquisition and internal development programs that Leasco has pursued, we have emerged a fully integrated company.

COHEN:
Yes, it appears that you have effectively integrated
Reliance, for example—and from a shaky start. I remem-
ber that Bill Roberts (president of Reliance) was op-
posing you quite vigorously at the beginning.

SCHWARTZ:

Mr. Roberts was a successful manager of a good com-
pany and was not interested in merging with anybody. His reaction against Leasco was typical of any action he
would have taken against any attempted merger. How-
ever, after we met with Bill several times and demon-
strated that we had sound concepts for the management
and direction of the joint operations of our companies,
I think he recognized the virtues of our association.

Still Roberts negotiated hard for his stockholders. As
you remember in the Reliance situation, we changed the
package after we met with him to make our preferred
stock five years and no call, and we lowered our con-
version price from 100 to 90. That was due to our nego-
tiations.

Also, we agreed not to interfere with the operations in
the insurance end for five years. Roberts felt that he and
his associates could continue in the insurance end to do
what had to be done, and we agreed wholeheartedly.

Today Bill Roberts is not only on our board of direc-
tors, but sits on our Management Review Committee. It

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is important for all of our managers to recognize that this
is a partnership effort, and Bill has responded to that
climate by being a full participant.

COHEN:

Many people have commented that Leasco has been
fortunate in being able to attract, and keep, good people.
Do you have a secret for this success?

SCHWARTZ:

Generally, there are three. We have been able to
create an environment of excitement. Leasco has been
a successful company. There are few companies that
have been built up as fast and as well as we, so we have
been a dynamic company and successful people want
to be with successful companies that are doing things.

Second, all of our key people have equity positions in
the company, either with stock options, or through stock
purchases. More than 10% of the entire equity of the
company is represented by stock options. Our people
are not only interested from the point of view of environ-
ment, but they are interested from the point of view of
helping their own equity.

And third, we have an atmosphere in which all ideas
are welcome, regardless of the source. People here have
the opportunity to see translated into fruitful actions the suggestions they make—and that is an important motivation for them. We have been fortunate also in receiving valuable help from our professional people. You know Touche Ross was our first accountant after we became public, and your people have taken as great an interest in us as our own people have. We get the kind of service and the advice that we have been able to rely on. That has helped us to be so successful.

COHEN:

Well, Bernie, we've talked about a number of major acquisitions—and you've had more than 15. What are the plans for the future, not as to specific companies, but certainly as to prospects for further acquisitions?

SCHWARTZ:

I think the company after only eight years has matured in terms of identifying the direction it is going. We will continue to investigate many areas and to identify those that we should be involved in. But our most immediate effort is the computer services business. In the near future we will be interested in making acquisitions only to fill gaps. I was going to make a prediction but like all predictions, I don't know if it will come true, but... I don't think in the next 12 or 13 months we will make acquisitions at the rate we have in the past. Our program has been very successful up to now, and we filled in many of the gaps.

COHEN:

What you're saying then is that these companies have a good future profit potential and you want to develop your acquired companies to the fullest.

SCHWARTZ:

Absolutely. Just to give you an example, we acquired one company a year ago. At the time the merger was consummated, the consideration was 27 times earnings. Today, based on the consideration we gave them at that time (but in relation to the earnings that they made this year), we paid nine times earnings, and on next year's anticipated earnings, it will probably be about four to five times earnings. Now that's a successful acquisition and I suppose we will always be interested in an acquisition that will perform similarly.