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No 1

MERGERS AND TAKEOVERS: SHORT AND LONG-TERM ISSUES

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INQUIRY INTO CORPORATE TAKEOVERS IN THE UNITED KINGDOM

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The David Hume Institute has been commissioned by The Joseph Rowntree Memorial Trust to conduct an Inquiry into the issues raised by Corporate Takeovers in the U.K. This paper is the first of a series presenting the results of research undertaken in the course of the Inquiry, and also submissions of opinion received from individuals and organisations which are thought to be of wide general interest. The Institute hopes in this way to keep the public informed of work in progress. The Final Report will appear in the late Spring of 1991.

The Institute has no collective views on any public policy question and is not committed to the views of any of its authors.

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Mergers and Takeovers: Short and Long-Term Issues.

Mergers and takeovers have always been important elements in competitive capitalist economies. There is scarcely any large company in the UK which has not built itself up partly by this route. In a free market system the patterns of business activity must be continually changing to meet changing demand. Companies form and grow and may stagnate, decay, and die. Regrouping by mergers and takeovers maintains growth and profitability and so wealth creation.

Most takeovers take place by friendly arrangement between companies and do not emerge into the forum of public debate, unless there is a prima facie breach of monopolies legislation. But some are contested initially by the board and management of the targeted company who then seek to influence their shareholders not to sell their shares and control of the company to the bidder. Boards of directors have the natural interest of preserving their jobs but they also represent the interests of those who work for the company, its culture, tradition, and standing in the community. To oppose successfully a takeover, the directors have to persuade their shareholders to vote against it, or produce an alternative, more acceptable, bidder (a white knight), or get government to use what powers it may have to intervene.

The pure free market view is that there can be no case for government involvement in a contested bid. If a bidding company is ready to offer shareholders of the targeted company a substantially higher price than the current market price, it is proclaiming its conviction that it can make the skill, assets and goodwill of the company work much more profitably than it is doing under existing management. Groups that specialise in taking over and reorganising companies (Hanson is the best known UK example) claim that they use their skills to revive poorly performing companies, some of them very large, which otherwise through management incompetence would have remained sickly, and even gone under, to the harm of the national economy.

On the other side there is evidence that takeovers, particularly large ones, are as likely to be unsuccessful in economic terms as to be successful. While the shareholders of the targeted company will probably do better immediately by being bought out than if the bid had been rejected, the shareholders of the bidding company may well lose out. This is not surprising. The board of the targeted company will by its resistance have pushed up the surrender price to the furthest limit of what the company is worth with its existing activities, and perhaps beyond. The bidder must have a very clear plan of how it can add to the value of its target if it is to make the new group perform better in earnings per share than it would have on its own. When large companies are brought together there are problems of integrating management. Each company has its own culture. For continuing commercial success there must either be a fusion of cultures, difficult to achieve quickly, or the dominant culture must supplant the weaker one, involving extensive replacement of senior management and consequent upset to the organisation. Takeovers are sometimes made not because the bidder hopes to strengthen its existing activities thereby, but in order to diversify the group's operations into new fields. Such excursions have a high failure rate. Senior managers are trained to be flexible, but they often fail to understand the essentials of industries far removed from their own. Lastly, many takeovers are made not by commercial logic but simply because businessmen are always keen to extend their empires. The subordination of profitability to power brings unhappy results.

It has been strongly argued that takeover activity and the threat of takeover, a real fear for all managements regardless of the size of the company, forces managers to concentrate on short-term earnings and neglect the long-term development of their companies. Further, financial takeover specialists who need a quick flow of earnings or capital from disposals to pay back loans incurred to fund the takeover, will be inclined to scrap slowly maturing developments and disband research teams. This argument collects added weight from the observation that in the two strongest of the industrialised economies, Germany and Japan, both with extended horizons of industrial development, there is virtually no takeover activity.

The concentration of the short-term is a general malaise of the UK economy and cannot be ascribed simply to takeover activity. Takeovers are partly a sign of industrial frustration, when companies cannot see their way forward in their own industries and look for new paths. British companies may neglect the long term because they have lost confidence that they have the capability, e.g. in design, engineering or labour skills, to make bold commitments to the future. It may be that Japan and Germany have less takeovers because of their steady industrial growth and success, not vice versa, and that their focus on the longer term stems from this. Nevertheless there is plenty of evidence that if companies were less preoccupied by the danger of bids they would plan and invest further ahead.

A further strong argument against takeovers is that they can lead to undesirable concentrations of power regionally and nationally with adverse effects on the societies concerned. A recent survey has shown that between 1985 and 1987, the control of 16 out of the 79 listed industrial PLC's based in Scotland moved outside Scotland through merger or takeover. Some of these changes were no doubt helpful to the Scottish economy in strengthening activities that otherwise might have been in trouble. But the migration of the control centres of companies, with top management, support staff and perhaps research facilities, can only impoverish Scotland as a community and prejudice its future economic development. The same trend may well appear in Europe as international barriers are removed. One of the nightmares of post 1992 EEC is that purely economic considerations will concentrate company power in the centre with cumulative effect, draining away the talent and power from the peripheral countries and regions, which will no longer have the traditional weapons to protect themselves with.

UK government policy in recent years has required intervention to stop takeovers only when these increase the share of the market to a level at which competition is substantially reduced, with the danger of prices being raised against the consumer. Other factors, such as national or regional control, may be taken into account but are rarely decisive. The present government, to the extent it has articulated policy, argues that the market capitalist system can generally be left to decide the best organisation of industry. Company law is framed to ensure that the affairs of the company are decided by the majority of shareholders. Shareholders should be able to see their own best interests as owners of a target or a bidding company, and this interest is likely to be to the general economic benefit of society. As regards the possible subordination of the long term to the short term, this can be, and often is, reflected in stock exchange values, and a government would be no more likely to make a sensible judgement on this than private shareholders.

Competition is a much broader issue than the aspects covered by government policy. Every company tries to ensure its survival and profitability by obtaining some advantage which its competitors cannot match. This may be in location, labour costs, brand names, design skills, indeed in any of the inputs that combine to make the final product. A company has achieved success when it has beaten its competitors at the game. In a mature industrial economy like our own many companies are already in this position, and so well protected against competitive attack. The takeover of rivals, even if not giving the group a critical market share, reinforces its position of competitive advantage, making it more difficult for new firms to enter the industry successfully, and helps it to extend market share in the future, a development which normally lies outside government cognisance.

Most governments, including our own, have not been much worried about the general concentration of power which takeovers often promote, arguing that their monopolies legislation will curb abuse of that power, large companies will be more efficient than smaller ones, particularly in export markets, and that freer trade will give the necessary stimulus to keep them efficient. But they are more sensitive to transnational takeovers, where what is seen to be a key firm in an industry or in the economy is in prospect of being taken over by a foreign company.

One can sympathise with government in its reluctance to interfere with takeovers. When political currents have been running so strongly against government ownership or direction of industry, it would seem perverse for them to interfere more in the market for buying and selling companies. Yet it is clear that contested takeovers do not find general favour except with the shareholders of the target company, who get an unexpected windfall, or by the management of the bidding company which increases its importance and power. Most people see takeovers as potential sources of social and economic harm to their community.

In the best of all possible worlds the disadvantages of takeovers would be taken into account by the shareholders themselves. If the shareholder invested his money for the medium or long term, knew and trusted the board and management which he had helped to elect, and appreciated the value of the company as an organisation in the community, many of today's takeovers would not occur. But these conditions are not found in mature industrial economies except in small companies and in unquoted companies, usually controlled by a family or an individual.

The development of stock exchanges makes shares in companies negotiable titles easily bought and sold without the assumption of any long-term responsibility. The holders of shares are, increasingly, large institutions, who do so on behalf of millions of individual savers and must be continually rearranging their holdings to secure the best return for their clients. Many institutions do build strong relationships with the companies they invest in, and most companies now make it their business to encourage this by frequent briefing. They hope also that if institutions appreciate the company's longer term plans, the share price will rise sufficiently to make the company no longer attractive to a bidder. But in the last resort the determining consideration for institutions and private shareholders is the price they are offered for their shares.

Companies do of course have the power through agreement with their shareholders to make themselves bid-proof by such devices as differential voting power for shareholders or interlocking shareholdings in other companies. In the absence of other defences company boards may feel justified in doing this, but in general it seems undesirable. Built-in restraints of this sort on the powers of existing or future shareholders may distort the future operations of the company to its disadvantage.

If it is accepted that government has some responsibility for the structure and organisation of industry, there seems a strong case for a broader policy on mergers and takeovers than we have at present. We are all well aware that a competitive market takes reasonable care of the proper short-term allocation of resources to create wealth. It is much less effective in dealing with longer term economics or with social issues. When economic activity is such a large part of all our lives, government should be as much interested in the consequences of mergers and takeovers as they are in other areas of our society.

There is a marked difference in attitude towards takeovers between UK and USA on the one hand and Germany and Japan on the other. The two English speaking countries look at companies as ad hoc mechanisms for delivery of wealth, which can change ownership as easily as houses or cars. The German and Japanese view sees them much more as social organisms, dedicated similarly to wealth production, but also having their own history, culture, and social responsibilities. In such an atmosphere takeovers are likely to be much rarer, with the interest of shareholders and management directed towards the longer term. In Germany the importance of the organisation and all its members, as against the immediate financial interests of the shareholders, is emphasised by the two-tier board system. In fact companies are very much the same throughout the advanced industrial world, as much social organisations as money making machines, and government would be unwise to ignore this.

One of the philosophic justifications for a private capitalist system is that it reduces the dominating power of government by providing other independent centres of power. This should surely be carried further. In a healthy society there should be multiple centres of economic power, well dispersed. Large corporations have a concentration of power which, however benevolently applied, inhibits free social development and probably also long-term economic progress, which depends more on the lively interaction of new ideas and technologies than on large-scale corporate planning.

The 1973 Fair Trading Act lays down a series of criteria for the MMC to apply in considering the public interest, including:-

S84 (c) of promoting, through competition, the reduction of costs and the development and use of new techniques and new products, and of facilitating the entry of new competitors into existing markets

(d) of maintaining and promoting the balanced distribution of industry and employment in the United Kingdom.

References of cases in recent years have been on grounds of direct competition restriction and not on the broader policy grounds set out in these clauses. Much of what was intended by the clauses could be achieved if government policy was framed to include the "maintenance of independent centres of economic activity". There have been strong arguments deployed recently in Scotland that mergers policy should be used to stop the takeover of Scottish firms by English or foreign companies. The theme of the branch factory economy has been an obsession of the Scottish Council for Development and Industry for many years, and with some justification. But it would be wrong to assess mergers only as a regional problem. The location of industry argument is only a special case of the more general case that dispersed centres of independent economic activity should be maintained. If merger policy helps to achieve this it will also help to keep the balance of industry between regions.

References to the MMC are at present normally only made for large mergers, presumably because only larger companies could bring about the anti-competitive effects with which government is mainly concerned. The same would have to apply when the criterion of centres of independent economic activity was applied. Takeover of small companies may remove independent economic activity, but in a healthy economy they will be quickly replaced by new companies, sometimes carrying out the same activity. When larger centres are removed the loss will not be made up so easily, if at all. The higher skills and knowledge of Rowntree in York, the company's goodwill, are lost to the country and it is difficult to see them replaced. (Indeed this is what made the takeover so valuable to Nestlé.) The size of the bidding company itself is not relevant to this policy, though it must be expected that larger targets will attract larger bidding companies. The new policy might well curb the activity of large companies seeking to diversify where acquisition would bring more aggregation of power, without bringing obvious benefits to the economy.

If this is to apply as domestic policy it must a fortiori apply internationally. There is a remarkable freedom for the foreign ownership of industry in most industrial countries. The UK government and British business have so far felt that an open policy in company ownership is justified by the reciprocal benefits we get abroad. But the time may come when takeover attention by foreign companies outside the EEC, or indeed within it, becomes oppressive and government, on quite respectable sovereignty grounds, seeks to limit it. We would no doubt have to apply the same criteria to intra-EEC mergers as we would to domestic ones, while securing that Brussels left us the freedom we wanted to devise our own policy. It would be perverse if we were precluded from applying a policy which, amongst other benefits, would help to correct the flight from the peripheries of the EEC to the centre, and then had to compensate, much less effectively, by massive injections of EEC money in those areas.

The attitude of the board of the target company should be given considerable weight. The board does after all represent the long-term economic and social wellbeing of the company, and has in this way an interest separate from that of the shareholders. The hostility of the board must be a prima facie indicator that the company's leadership has confidence in its successful continuance as an independent centre and also of the reaction of the company as a social organisation. On the other hand, a board that recommends a bid for acceptance, must be assumed to have decided this at least partly because it saw a better future for the organisation merged with the bidding company and was not confident that continued independence was an attractive alternative. It would be difficult for government to refuse a merger which had the approval of all concerned, even if a centre of independent economic activity was thereby removed. A board contesting a bid would have to do so, not tactically to put up the price, but in the conviction that it was to the advantage of the company as an organisation to remain independent. It would be more ready to take this stance if it expected support from MMC. If the board was thought highhanded by its shareholders in taking this stance, they would have the remedy of deposing it and electing a board that would make different representations to MMC.

The policy recommendation made in this paper may seem an unwarranted intervention by government in the economic system. But the problems are real and important ones. Takeover activity, despite the minor stock exchange crash of 1987, is still at a high level, much of it being by financial speculators who have the skills to exploit the imperfections always present in the share market for short-term gain, but have little interest in the development of the companies in which they invest. The issues have been masked by the immediate profits this activity gives to our large finance industry, though often at the expense of the future health of the rest of the economy. As a country we are curiously casual about preserving our industrial base. We make much more fuss about individual works of art leaving the UK than about important centres of industry going the same way.

Government policy would have to be firm and reasonably clear, but intervention would not necessarily be extensive. Once the initial policy principles had been established, takeover interest would drop and we might come nearer the German system, with boards and managers keeping their attention on organic growth, shareholders maintaining critical loyalty to their companies, and companies recognising social as well as economic purpose.

Summary

Government policy on mergers and takeover should be directed towards longer-term goals, discouraging concentration of economic and social power in large companies by the maintenance of independent centres of economic activity. This should apply principally in contested bids, where the targeted company declares its wish to remain independent.

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