

MERGERS & TAKEOVERS

1) Introduction

Mergers and Takeovers (or Acquisitions) are two methods used by corporations within the scope of corporate finance to expand their business structure and activities on the national or international arena.

A merger is said to take place when two companies of their own free will combine to form a larger company. There are three basic types of mergers: horizontal mergers, where two companies in the same line of business combine; vertical mergers, that combine a supplier and a user (such as an aero-engine company and an aircraft company); and conglomerate mergers, that join two companies in unrelated businesses. A merger is financed by a stock swap (called an 'all share deal' in U.K) that involves stock deals with neither company paying money.

A takeover or acquisition takes place when one company purchases another. In the U.K, takeovers are restricted only to public companies whose shares are traded publicly on the stock exchange. There are two types of takeovers: friendly takeovers, which take place with the full consent of the target company's board and shareholders; and hostile takeovers, where the bidder bypasses the board (on the grounds that it is not acting in the best interests of the shareholders) and wrests control by purchasing a majority of the target company's shares in the open market. A takeover is generally financed by cash, though in some cases the finance takes a dual feature such as a combination of cash and stock, or cash and debt.¹

¹ Wikipedia. (2007). *Mergers & Acquisitions*.

2) Why are mergers and takeovers attractive to Management?

The first reason why mergers and takeovers are attractive to Management is that a near or total monopolistic market domination is created. The combination of two companies result in more power in the market, effectively shutting out competition, and creating a situation conducive to increasing production and dictating prices at will. In case of vertical mergers, the advantage of cross-selling contributes to a powerful position (for example, a car company that takes over a care tyre company can switch over to using those tyres during its car manufacturing process, as well as strongly promote their sale to customers seeking to replace their car tyres). This is the result of the synergism phenomenon, wherein two or more entities combine their actions to ensure a result greater than foreseen by knowing only the separate effects of each entity.²

The second reason is that the company grows healthier financially as a result of the merger or takeover. Overall costs are radically lowered because the economies of scale rule that the production process results in an increase in the number of units produced, while the average cost of each unit drops significantly. Cost-reduction, combined with increased production and a wider clientele can only have one result – a healthier company making more profit. In case of a takeover, the acquiring company can further increase profit by purchasing a loss-making company and using its tax write-offs to evade or reduce tax payments.³

The third reason is that the company's image to outsiders is enhanced. An important feature of mergers and takeovers is that they spread investment results in a 'smooth'

² Wikipedia. (2007). *Mergers & Acquisitions*.

³ Ibid.

earnings trend of the company in the short term. In the long run, this 'smooth' trend also spreads to the company's stock price, which results in portraying such stock as safe and attractive to prospective investors.⁴

The fourth reason is that the financial earnings of management personnel are greatly increased. As most companies pay management by salary plus a share in the total amount of profit the company makes, the prospect of increasing profit (and having a healthy share of it) by a merger or takeover becomes very appealing to management. Apart from profit sharing, management salary itself is increased. As a result of the foregoing three reasons, and the fact that they are now managing a much larger entity - one that has expanded its market and profit - management salaries are generously increased.⁵

The last reason follows the above four, namely, management personnel becomes more powerful, a situation that is extremely satisfactory to them personally. The new position is the culmination of their efforts in the drive for power, striving for status and desire for achievement. Power is a strong psychological motivator that creates in them a strong desire to excel in their job, thrill in the satisfaction of achievement and enjoy the resulting boost in status and finance.

3) Does society ultimately gain?

Society in general suffers due to mergers and takeover activities.

First of all, a merger or takeover involving a foreign company can be deemed as compromising national security and therefore, dangerous to society; a prime example is the public outcry in the U.S. when United Arab Emirates-based Dubai Ports World was about to clinch the deal involving operating 6 ports in the U.S.A.; the unprecedented

⁴ Wikipedia. (2007). *Mergers & Acquisitions*.

⁵ Ibid.

public opposition (fuelled by apprehension in the wake of the 9/11 disaster) led to a hurried scrapping of the proposed deal.⁶

Secondly, the combination of two competing companies means that neither need maintain competitive prices as the monopolistic conditions created by the merger or takeover allows them to raise prices without opposition; society has to bear the brunt of such price increase.

Thirdly, shareholders of companies where management remuneration is linked to total profit generated by the company (as opposed to profit per share), stand to lose, as such management would be enticed to strongly push for mergers or takeovers with the aim of increasing total profit of the company (and thereby their own remuneration), unmindful of the fact that such a move would result in a decrease in profit per share.⁷

Lastly, mergers and takeovers almost always result in unemployment; citing radical improvement measures, existing employees who are deemed unfruitful are terminated, and the overall size of the workforce is reduced. For the terminated employees, finding new employment is not always easy, particularly if they are hampered by age constraints.

Merger and takeover activity is seen as beneficial to society in just one scenario: a hostile takeover. This type of takeover - wherein the bidder evades the target company's board that stubbornly and unreasonably refuses to compromise, and purchases a majority of the target company shares in the open market - essentially opens a new avenue to shareholders (as opposed to relying solely on the company's board, who are perceived as not performing in the interest of shareholders), in that they stand a very good chance of

⁶ Platt, G. (2006). *Heightened National Security Threatens Global M&A*.

⁷ Wikipedia. (2007). *Mergers & Acquisitions*.

receiving a better deal after the merger or takeover.⁸

3) Recent examples of U.K mergers and takeovers & their perceived effects on society

In the period leading up to the year 2007 there have been several prominent mergers and takeovers in the U.K.

In August 1998, British Petroleum (BP) completed a U.S. \$ 110 billion merger with Amoco.⁹ The merger does not have any price-raise detrimental effect on society because the price of oil and oil derivatives are strictly controlled by the government which in turn responds to a well-set international price structure that is regularly reviewed as and when political events around the world affect oil supply. There is no threat to national security because Amoco is of U.S. origin (a country very safe to deal with, from the U.K point of view). Given the oil sector's insistence on professional employees, the merger is perceived not to have any adverse unemployment effect on society. There is a good chance of a steady increase in shares price, which is beneficial to society.

In February 2000, Tata Tea (India) announced a U.S. \$ 400 million takeover of U.K.-based Tetley.¹⁰ The friendly takeover does not involve any monopolistic price hiking effect on society as there are many brands to comfortably choose from (such as the leading brand PG Tips, Brooke Bond, Lipton and Ridgways). There are significant chances of unemployment being created by the merger, as management adopts cost saving measures (the leading one being termination of perceived non-productive workers). Prices of shares are definitely inclined to rise steadily, which is a boon to society. The tea sector does not constitute a national security zone by any stretch of

⁸- Wikipedia. (2007). *Mergers & Acquisitions*.

⁹- Ibid.

¹⁰- Srinivas, A. (2007). *Corus Takeover: Who is Ratan Tata?*

imagination (and even if it remotely does, India is undoubtedly the safest and most reliable partner in South Asia).

Also in the year 2000, U.K drug giants Glaxo Wellcome plc and SmithKline Beecham plc completed a U.S. \$ 76 billion merger, creating GlaxoSmithKline (GSK), the largest pharmaceutical company in the world.¹¹ Given their formidable structure as a result of the merger, there is a definite fear of GSK raising prices on all products, which is detrimental to society. Another adverse effect would be unemployment, as the new structure trims its employee salary budget. The advantage to society would be the increase in share prices as a result of the high profile merger. There is no question of national security being compromised because both companies are based in the U.K.

There have been 3 prominent takeovers in the year 2007.

Tata Steel (India) completed a takeover (the largest by an Indian company) of London based Anglo-Dutch steelmaker Corus on 31 January for £ 5.75 billion. The friendly takeover, which followed on the heels of 14 other takeovers worth U.S. \$ 1.5 billion completed in 2005 / 2006 by the Tata Group, is seen by analysts as a protective measure against probable hostile takeover of Tata Steel by London-based Indian Lakshmi Mittal, who completed the takeover of Arcelor in 2006 to emerge as the world's leading steelmaker.¹² The international steel industry, like the oil sector, is very streamlined and there is no chance of an unreasonable hike in steel prices as a result of this takeover (and even if there were, the presence of the world number one steelmaker Lakshmi Mittal would act as an effective deterrent). A slight unemployment ripple may surface as management tries cost saving measures. Society will benefit from the increasing trend in

¹¹- Wikipedia. (2007). *Mergers & Acquisitions*.

¹²- Srinivas, A. (2007). *Corus Takeover: Who is Ratan Tata?*

share prices of the companies involved. The threat to national security, as mentioned earlier, does not hold water as India is a safe partner for the U.K.

On 2 January, Carphone Warehouse finalised the takeover of America On Line (AOL) U.K which is ranked third in the country in the internet service sector. The takeover that was worth £ 370 million, not only gave mobile phone retail giant Carphone access to 20 per cent of U.K's broadband market with a customer base of 2.1 million internet users, but also won the distinction of being the first company to offer a combined service of telephone and internet under the banner of the brand Talktalk. Conservative estimates of an additional £ 10 million (2007) and a total £ 40 million (2008) in pre-tax profits are forecasted as a result of this transaction.¹³ Given the powerful structure that evolved as a result of the friendly takeover, there is a definite chance of price increase to consumers. Society will benefit due to increase in share prices as a result of the takeover. There is very little chance of unemployment due to the presence of a well-established retail network of telephone and internet service providers in the country. National security is not compromised as Carphone Warehouse is based in Ireland.

Following the example of Chelsea Football Club's takeover in 2003 by billionaire Russian Roman Abramovich, and Manchester United Football Club's takeover in 2005 by U.S. billionaire Malcolm Glazer, Premier League football club and 2005 European Champions Liverpool Football Club was involved in a takeover on 6 February 2007 by two U.S. billionaires for £ 219 million; this figure included debt and a calculated value of £ 5000 per Liverpool share. The deal included an undertaking to build a new 60,000 seat stadium at Anfield, and an undisclosed annual budget to cover salaries of team

¹³ Reid, S. (2007). *Carphone Warehouse Completes £ 370 Million AOL UK Takeover*.

management, club executives and player transfers. This takeover deal with George Gillett (owner of U.S. National Hockey League {NHL} team Montreal Canadians) and Tom Hicks (owner of Major League Baseball {MLB} team Texas Rangers and NHL team Dallas Stars), was considered better than the bid from United Arab Emirates-based Dubai International Capital (DIC).¹⁴ The advantage to society is the increase in Liverpool fan satisfaction with the new club structure: a new stadium in Anfield is on the cards, the club manager Rafael Benitez (given the new lavish player transfer budget) is sure to buy top soccer players, thereby enabling Liverpool FC to develop into a more formidable opponent on the Premier League as well as European soccer stage. The takeover by the two U.S. tycoons forestalled any national security threat that would otherwise have arisen if DIC had won the takeover.

5) Are current controls on mergers and takeovers adequate?

Current controls on mergers and takeovers in U.K are adequate for three reasons. I have identified two areas in which controls could be made more effective.

The tax efficient framework prevailing in the U.K serves to make U.K companies more competitive in merger and takeover activities. These tax rules, known as “Controlled Foreign Company” (CFC) regulations, came under the international spotlight when the EU Advocate General gave the Cadbury Schweppes Opinion on 2 May 2006. Cadbury Schweppes, a U.K company, was charged under U.K tax rules of tax avoidance tactics by establishing two wholly owned Irish subsidiaries. The Advocate General ruled in favour of Cadbury, saying its action of establishing a subsidiary in a Member State for the sole purpose of gaining benefit from that State’s more beneficial tax framework was

¹⁴ Noble, P. (2007). *Liverpool FC Agree U.S. Takeover*.

not illegal, and fitted lawfully within the EU “Freedom of Establishment” principle.

Analysts like Tobias Ackert, tax partner at Allen & Overy in Frankfurt, see the Cadbury ruling as a motivation (perceived encouragement in setting up commercial operations in low-tax areas) to change present EU tax rules, and expect this would divert merger and takeover activity to tax efficient countries (like the U.K) because, in Ackert’s words: “a tax efficient framework is one of the drivers of merger and takeover activity.” Ackert’s view was echoed by Patrick Means, tax partner at Allen & Overy in London, who said: “In the long run, a review of the CFC system will be encouraged and there will eventually be a leveling of the playing field in the EU tax regime.”¹⁵

The second praiseworthy controlling measure is the efficient “Office of Fair Trading” (OFT) which is governed by the “Fair Trading Act” of 1973. OFT reviews applications for mergers and takeovers and has admirable safeguards in place such as inviting reviews from affected players like competitors, suppliers and customers; it refers suspect cases to the Competition Commission; it may however try to help deviating proposals by calling for, and accepting undertakings that are intended to remedy perceived detrimental effects of the merger or takeover. In the year 2006, the OFT blocked the proposed merger between Eurotech S.p.A and Radstone Technology plc in September; in the same month it cleared the proposed merger between Balfour Beatty plc and Birse Group plc; in July it referred the proposed merger between Hampden Agencies Limited and Christie Brockbank Shipton Private Capital Limited to the Competition Commission; in December it accepted undertakings and cleared the proposed merger between Aggregate Industries Limited and Foster Yeoman Limited. During 2007, it cleared the proposed

¹⁵ Chessa-Florea, M. (2006). *Cadbury Schweppes ECJ Opinion on Controlled Foreign Company Rules may encourage UK M&A Activity – Analysis*.

merger between Linpac Materials Handling Limited and Allibert Buckhorn Group in January; it blocked the proposed merger between Brocade Communications Systems Inc. and McDATA Corporation on 1 February; on 7 February it asked for undertakings (if not satisfactory, then referral to the Competition Commission would follow) from proposed merger companies Flybe Group Limited, BA Connect and British Airways plc; and on 26 January it referred the proposed merger between Kemira GrowHow Oj and Terra Industries Inc. to the Competition Commission.¹⁶

The third laudable control is that U.K presently allows mergers and takeovers only of public companies. Privately owned companies (meaning those entities whose shares are not listed on the stock exchange), owned by either private individuals or non-governmental organisations are not allowed to adopt these transactions. The main reason for this is the 'secrecy' element – these private entities' anxiety about secrecy stems from the probable unhappy and discouraging response they anticipate from crucial players like customers, bankers, suppliers and employees. The secrecy requirement has so far frustrated and prevented the existence of a marketplace to act as a clearing house for a large volume of business.¹⁷ Governmental control is thereby seen as an encouragement to such companies to stay away from the potential hazards involved by indulging in mergers and takeovers.

The first control area which needs tightening concerns screening proposed mergers and takeovers involving foreign companies;¹⁸ analysis should be strengthened keeping in mind changing political climates, especially those affecting national security. For

¹⁶ Oft.gov.uk. (2007). *Business Information*.

¹⁷ Wikipedia. (2007). *Mergers & Acquisitions*.

¹⁸ Platt, G. (2006). *Heightened National Security Threatens Global M&A*.

example, in the current world context, there is no doubt that the Middle East and certain South Asian countries are perceived as areas from where terrorist activities originate; therefore, mergers and takeover proposals involving companies from these areas merit very detailed scrutiny. In the U.S., as a result of the 9/11 terrorist attacks, Middle Eastern takeovers of U.S. companies fell from 15 in 2000 to 3 in 2003, and 2 in 2004; early 2006 witnessed a high profile case where, just as the merger was about to be passed, the proposal of Dubai Ports World (United Arab Emirates) to manage 6 U.S. ports was cancelled due to vociferous public opposition on a scale never before experienced. The post 9/11 period saw the U.S. Senate Banking Committee authorise the “Committee on Foreign Investment in the United States” (CFIUS) to minutely scan (within a period of 60 days) and if it needed, block foreign takeovers.¹⁹ In my opinion, the U.K should emulate the U.S. example by creating a specialised body within the OFT solely responsible to screen proposed mergers and takeovers between foreign companies and those in the U.K. It must be said at this point that the U.K is moving towards the right direction as exemplified by Liverpool Football Club which rejected the takeover bid of United Arab Emirates- based Dubai International Capital (DIC), instead accepting the bid from U.S. tycoons Tom Hicks and George Gillett.²⁰ However, such a specialised body within the OFT should take care not to let national security concerns overlap with protectionism. There have been several high-profile international cases recently which have drawn criticism – one among them is the blocking of PepsiCo’s proposed takeover of French Group Danone by the French authorities.²¹ The proposed specialised body within the

¹⁹ Platt, G. (2006). *Heightened National Security Threatens Global M&A.*

²⁰ Noble, P. (2007). *Liverpool FC Agree U.S. Takeover.*

²¹ Platt, G. (2006). *Heightened National Security Threatens Global M&A.*

OFT should therefore adopt fair and unprejudiced measures while screening foreign mergers and takeovers.

The second area when control can be made more effective concerns private equity houses. Private equity, which basically involves investing in securities through the process of discussion and compromise, has emerged as a major player in the alternative investment arena. The Deloitte research report (January 2007) that is based on an analysis of 1,065 transactions of U.K companies during 2005/2006 valued around £ 113 billion, plus interviews with 65 FTSE 350 CFOs, backed by analysis of 64 deals, firmly declares that private equity excels in the U.K mergers and takeover market, whereas the relative corporate share is very less. The report puts the current success rate of private equity in auctions at 74 per cent as compared to just 30 per cent five years ago. The report goes on to cite the main strengths of private equity as compared to corporates: a strong concentration on attaining success and regularly checking progress; specialised skills in examining different stages in the life cycle of the target company; a larger outlay of funds for detailed research of the proposed merger or takeover; a stronger incentive programme for management; and a significant transparency of purpose leading up to the merger or takeover. Most of the interviewed CFOs admitted that private equity capability is much higher than their own, and more significantly, they feel that this trend will increase in time to come.²²

6) Conclusion

In the current world scenario, U.K is doing well, holding its own, especially with regard to its tax framework and the activities of the OFT. It is important that

²² McLindon, A. & Quinn, C. (2007). *Corporates Blame M&A for Poor Performance While Overestimating Their Own Capability – Deloitte.*

improvements should be carried out in tandem with other countries in response to political changes and developments in the world. National security should be the paramount concern. A firm step in this direction (although it does not have direct connection to our topic, but is mentioned as a laudable national security measure in response to current world politics), is the sudden U.K decree in March 2005 stating work permit-free visas would no longer be issued to non-European Union doctors.

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