MERGER MANIA -

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The recent trend for cross-border mergers appears to be continuing in 1998. But who are the winners of all this activity… apart from the corporate advisors? **Chris Higson** gives the answers.

In recent months a number of corporate mergers, sometimes very large, have been proposed or agreed. A significant number of these have been cross-border, and involve European companies. A clustering of mergers of this sort has a big impact. Clearly takeovers have major implications for the structure of industry and competition in those sectors of the real economy that are involved. And when the takeovers are cross-border the anxieties about employment and economic governance are accentuated.

But a spate of takeovers also creates waves in the City. One group which profits mightily from high levels of corporate restructuring is the advisors. Investors may profit mightily too since takeovers usually involve a significant shift in the stock price of at least one of the companies involved. If there is a spate of mergers, this promises more to come and investors engage furiously in predicting where they will be, since the returns to identifying correctly a takeover target before the rest of the market would be very high indeed. The exceptional performance of the FTSE over the last year has been driven by the largest firms, and a good part of this reflects the market's anticipation that these firms are of sufficient scale to benefit from the global restructuring of their sectors.

In this article, I want to put the recent spate of cross-border mergers into context. I will be discussing two issues. First, why are these mergers happening now? Are they, as has frequently been suggested, a response to the euro and if so will we see more euro-inspired takeovers! Second do they have industrial logic, and are they good for shareholders? I will start, however, by recalling some lessons from history.

Waves of merger activity are as old as capitalism itself. The mid to late '80s saw a lot of takeover activity, both by number and in terms of value, and takeover markets have been buoyant ever since. But the depth of economic restructuring was no greater than had been observed on several occasions over the previous 100 years. We still understand very little about the process that generates these periodic upheavals. We do know that, by and large, they occur when stock markets are strong. But we do not know why this is so, and researchers have not managed to produce any convincing way of predicting which companies will be bought, or which sectors will restructure and when. Though in some cases there are regulatory changes which act as triggers, in general we do not really know why sectors restructure when they do. Moreover, in terms of financial characteristics there is little to distinguish companies that are bought from those that are not. Certainly acquired companies are not less profitable, but typically they have experienced lower market to book ratios in the year or two prior to the bid.

There has been a natural tendency to link some of the cross border mergers to the imminent arrival, in most of Europe at least, of a single European currency. However, taken literally, this argument would lead you to the opposite conclusion. One rationale for multinational firms is that they can reduce the costs of doing business internationally. The cross-border company, the multinational, presumably has its own internal currency or unit of account which offers some efficiencies in a world of multiple currencies. The beauty of a single currency is that it reduces the costs of independent national entities dealing with each other; and it makes it easier for a company entity in one territory to reach out and do business in other territories. This explains some of the home market scale advantages that US corporations have been able to enjoy while still remaining domiciled in one state.

Consider another argument with a similar logic. Another part of the business logic for multinationals was that they provided investors with a way of getting international portfolio diversification when fund managers were not providing it. Until perhaps five or 10 years ago there was an extreme and well-documented 'home-bias' by fund managers. Funds were denying investors a significant potential for risk reduction through global diversification. Putting this into the language of business strategists, multinationals had 'competencies' which, apparently, funds managers did not have. These competencies included a working knowledge of different cultures and the ability to work cross-culturally. In recent years the home-bias has reduced significantly. Modern financial technology makes it easy for fund managers to buy and sell foreign exposure, but, more interestingly, the equity investment houses have also become multinational. They have acquired the same competencies as multinational industrial companies. As a result the portfolio investment *raison d'être* for multinationals has been reduced.

More convincingly, we can place many of the mergers we are seeing within the process of globalisation of the world economy. What do we mean by the loose and all-embracing term 'globalisation'? Some industries, for example oil, have been global for as long as we can remember, and in many others the process of globalisation has been in train for decades. Globalisation has had a number of drivers including advances in information and communication technology, advances in travel, the reduction of barriers to trade and the growth of overseas markets that could no longer be ignored. From all these sources has come a change in the mental model of the manager, an increasing tendency to conceive of opportunities, and threats, internationally rather than locally. What characterises the current business environment is that we now see all industry as potentially global, and see all industries as in play.

How should we react to the spate of cross-border mergers? Will they, and indeed globalisation itself, invariably be 'a good thing'? The answer is that they will stand or fall on just the same tests as mergers always have in the past. There are always two questions with a merger. The first requirement is for a business logic. In what way will the combination create value and strengthen the competitive position of the firms involved? The second test is the price test. The question now is 'There is a business logic, but can it be achieved without overpaying a full price?' This is the tougher test.

There are some convincing generic arguments that apply to many of the takeovers we are witnessing. Mergers usually lead to increases in size, and the motive for increasing size is usually to leverage or exploit more fully some key resource. This observation is rather obvious and is too general to be useful, but take the concrete example of 'distribution'.

The globalisation project in the music business has been in train for a decade or two. Polygram, the largest of the three or four companies that now dominate the global music business achieved this position through a series of takeovers of smaller and larger record companies including Motown, Island, and A&M. Polygram is a very well managed firm with a number of distinctive competencies, but probably the secret of these acquisitions was the acquisition of product that had hitherto been exploited nationally or regionally, pushing it through a bigger, in this case global, distribution network. This model, the acquisition of brands or product in a combination with a global distribution capability, has many applications. We see a similar business logic in many branded-goods consolidations, a decade ago in the Nestle acquisition of Rowntree and the Guinness acquisitions of Bells and Distillers. The current spate of mergers in insurance and financial services may be argued on a similar logic.

In the case of the big six accounting firms the argument for scale is rather different. Price Waterhouse and Coopers & Lybrand are both firms that already possess excellent global brands. But they have argued strongly that they need to be larger to leverage the very large investments which they make in resources such as IT, training, and in the building and maintenance of professional expertise. On this argument only Andersen are of efficient scale in their industry.

But there are business costs to 'e growth by merger, which are very frequently ignored in the enthusiasm of le the sponsors. Researchers have devoted much effort over the years in seeking to understand why it is that so many mergers disappoint, and are ultimately declared failures even by those managers who were closely involved in implementing them. It has become clear that there is an endemic tendency to underestimate the costs of integrating separate businesses, and most particularly the difficulties of combining cultures. The companies who do best at the mergers game have tended to be those that have consciously developed very specific expertise in post-merger integration; these will often be the companies practised in acquisitions. Research at London Business School has shown that mergers very often fail because of a failure to understand the human-resource issues. When mergers fail it is commonly because they failed to over- come deep cultural differences in the organisations involved.

In summary, a cross-border merger still needs a business logic. Scale arguments, leveraging resources, will often be relevant in the global economy. But this logic does not apply in all sectors. For example the business logic in cross-border ownership of the utility companies is less compelling. On the other hand, it seems likely that cross-border merger will offer even greater cultural challenges to integration in many cases. Given the importance of 'softer' issues such a culture, particularly in the integration of professional service organisations such as accounting firms, it is a pity that these are so rarely addressed when the merits of mergers are being debated.

Finding a strong business logic is the first hurdle, but the tougher problem is how to con- summate the deal without overpaying. Even when value will be created there are very great pressures to give away the value gains in the premium.

Research at London Business School suggests that on average acquirer shareholders gain nothing from the merger and that behind this average, 55 per cent of acquirers pay too much. During the merger wave of 1985-90, 65 per cent of UK acquirers apparently overpaid. These results should not be surprising. They are just what would be expected in a competitive takeover market. Mostly there will be another actual or potential bidder who could capture some or all of the synergies, so the bidding process turns, explicitly or implicitly, into an auction. In a seller's market the value gains go to the seller, and the winner should expect to hang on to value only if it results from a synergy available to them uniquely.

There is no reason to believe that global mega-mergers will be immune to the timeless temptation to pay a 'full price' or even to over- pay, and we must assume that a fair number of current mergers will turn out to involve overpayment.

Does overpayment matter? In an important sense, we should worry less about overpayment than we do about mergers with no business logic. In the latter case society's scarce resources may be put to inefficient uses. Over-payment may lead to takeovers being undertaken which should not have been, but in the main the result is simply the transfer of wealth from one investor to another or, in the case of the portfolio investor, often from one pocket to another. Investors will care about this, but society less so.

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