Northwestern Journal of International Law & Business

Volume 9
Issue 3 *Winter*

Winter 1989

Problem of Mergers

H.W. de Jong

Recommended Citation
H.W. de Jong, Problem of Mergers, 9 Nw. J. Int'l L. & Bus. 605 (1988-1989)

The Problem of Mergers

*H.W. de Jong**

Mergers and takeovers are again the order of the day. In North America, Europe, Australia, Africa and East Asia, firms try to combine, to take over, and to cooperate in joint-ventures. The combination phenomenon has risen spectacularly during the past few years: Figure 1 demonstrates that mergers and takeovers, undertaken by the 1000 largest European companies, rose from a level of some 150 per annum in the period from 1976 to 1983 to over 400 in the year 1987 alone. These were mergers in the manufacturing, energy, building and construction sectors, as well as in distribution and services.[1] The European Community Competition Policy Reports also document an appreciable rise in acquisitions of minority holdings and in joint ventures, both of which have more than doubled during the past six years.

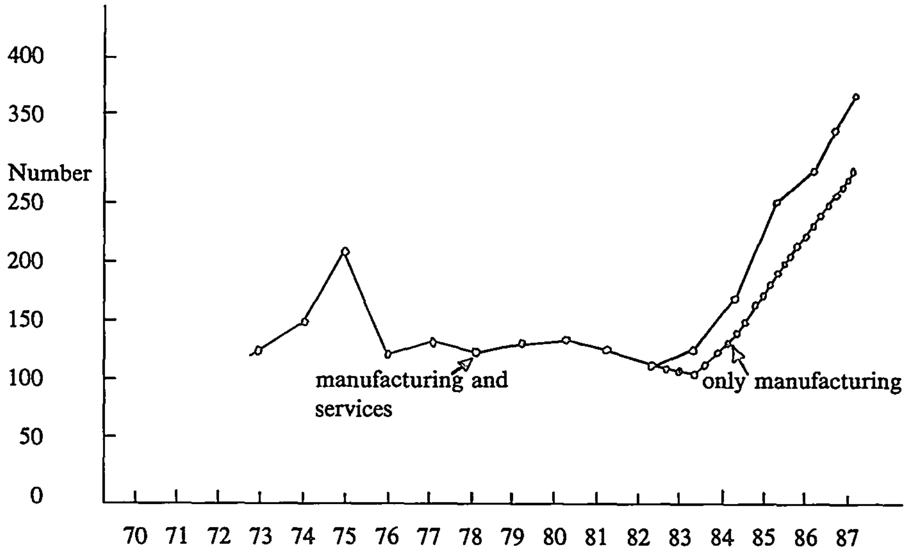
In Australia, "some 220 of the country's top 500 companies have been merged, acquired or displaced over the past six years," and that "change in enterprise mix represents nothing less than a metamorphosis of Australian business."[2] In South Africa, the corporate descendants of the nineteenth century robber-entrepreneur (and instigator of the 1895 Jameson raid) Cecil Rhodes, Anglo-American and Consolidated Gold Fields, are involved in a battle for control, of which the opening gambit is worth $4.9 billion. Kuwaiti investors increasingly have been penetrating European countries and were recently ordered to divest part of their shares in British Petroleum. Japanese corporations have aggressively joined Europeans in buying-up United States companies, and a total of 745 United States firms were acquired by corporations from five Euro-

* Professor of Economics, University of Amsterdam

1 Figure 1 is derived from the annual information given in the Commission of the European Communities Report on Competition Policy, for 1973-1988, and covers only mergers and acquisitions. *See also* H. de Jong, The Structure of European Industry (1988).

2 Fin. Times, Sept. 30, 1988, at 6, col. 1.

Figure 1. EEC: Large-scale mergers and takeovers in manufacturing industry 1973-1987 and service trades.



pean countries and Japan in the period 1980-1986.[3]

This evidence, which could easily be multiplied, points towards one general characteristic of the merger and takeover phenomenon: mergers, takeovers and other combinations *occur in waves*, and each of these waves has its radiations throughout the economically relevant world. Four merger waves have been distinguished during the past one hundred years:

(1) From 1885 to 1903: A wave of consolidation and monopolization was prominent in the United States, the United Kingdom and Germany, but was also present in other countries.[4]

(2) From 1918 to 1930: A wave of combinations, during which oligopolistic markets arose in the United States and dominant market positions were created in European countries (for example, United Steel in 1918, Tube Investments in 1919, ICI in 1926, and Unilever in 1929, in the U.K.; Daimler Benz in 1926, Osram in 1919, M.A.N. in 1922, Vereinigte Stahlwerke in 1926 and I.G. Farben in 1926, in Germany). In Japan, the Zaibatsu structures were formed combining the modern top-holding company (the Honsha) with a feudalistic loyalty.[5]

---

[3] Fin. Times, Sept. 8, 1987, at 6, col. 1.

[4] In the Netherlands, A. O. Royal-Dutch Shell and the leading sugar and brewery firms were constituted in that period. In France, the Thomson group took shape, and firms in Belgium, Austria and other countries were active as well.

[5] E. HADLEY, ANTITRUST IN JAPAN 78 (1970). *See also* W. LOCKWOOD, THE ECONOMIC

(3) From 1960 to 1973: A wave of diversifications and conglomerate formations occurred in the United States, and was matched in Europe by a predominantly horizontal concentration movement. In Japan, the loosening Keiretsu structures accompanied declining—and later stable—concentration ratios until the end of the 1960s, with only a few large mergers and high market fluidities.[6]

(4) From 1981 to the present: In the United States, this fourth wave rose to three successively higher levels (1978-80, 1981-83, and post-1984), while the European spurt started only in 1983, but subsequently gained momentum fast. (Note that the start of this wave preceded the announcement of the Cockfield Internal Market Proposals of December 1985). In the present merger wave, the Europeans continue with a heavy emphasis on horizontal mergers, although the diversification approach is not wholly absent. Also, some unrelated merger activity is notable, especially within big business.

Apart from the wave-like character and the intercontinental spread of the merger phenomenon, other characteristics are evident. First, the rise in the average merger-intensity accompanied an increase in the size of the firm. Acquirers are, on the average, much larger than the acquired firms. The high merger-intensity of big business is typical of all countries for which we have data: the United States, United Kingdom, France, West Germany, the Netherlands, and Sweden. Recently, Italian data has also supported this theory, demonstrating that it is the small firms, in terms of sales and employment, which predominantly are being acquired by large companies.[7]

Second, in the waves of mergers and takeovers, a handful of industrial sectors account for an appreciable share of the activity: in the European Community, three sectors (chemicals, machine tools and instruments, and food) accounted for 50% of all mergers and takeovers

DEVELOPMENT OF JAPAN (1954), stressing the contrast between the fast growing traditional industries, such as textiles, and the forced rise of the heavy industry and financial sectors, in which the Zaibatsu groups exercised control.

6 H. DE JONG, ENTERPRISE CONCENTRATION: THE DEVELOPMENT IN EUROPE, AMERICA AND JAPAN 212-43 (1971). There were indeed many Japanese markets with high oligopolistic concentration ratios of the three to five leading firms, but rank fluidity was very high. Of 90 important sectors of manufacturing industry, the rank order did not change in eleven sectors between 1955 and 1966. In all twenty-nine sectors in which the cumulative degree of concentration rose for the three largest firms, the rank order changed. *See* THE ORIENTAL ECONOMIST, PRODUCTION CONCENTRATION IN INDUSTRY 411-16 (1967).

7 A. BIANCHI & G. GUALTIERI, THE EXTERNAL GROWTH OF FIRMS THROUGH MERGER AND ACQUISITON: THE ITALIAN EXPERIENCE 1983-86 (1987). This research also noted the predominance of horizontal mergers and their sectoral concentration (59% of the acquirers in five of the twenty-six sectors distinguished), as well as the virtual absence of hostile takeover bids in Italy, due to the prevalence of family control.

during the years from 1982 to 1986. If the paper and electro-technical industries are added, the share rises to 69%. Similar high percentages achieved by five to eight major industries were visible in the turn-of-the-century European wave and in the earlier United States merger cycles, although the industries concerned were partly different.

A third characteristic is that, throughout the decades, premiums are paid for the firms being acquired, ranging from 20% to sometimes well over 100%.[8] Finally, a common result of the investigations of the effects of mergers and takeovers is that a substantial part of them were failures (one-third to 45%), a smaller part (15-25%) were not "worthwhile" and, consequently, barely one-half of the mergers and takeovers are successful. Acknowledging that one has to work with rather crude and arbitrary definitions about "success" or "failure" as well as the time period over which the outcomes must be measured, it nevertheless remains true that practically all studies tend towards the above mentioned results, whatever the country or merger wave concerned. For example, the seventeen major British consolidations between 1880 and 1900, involving the leading firms of the time, recorded eight outright failures (heavy losses, no dividends paid for one or two decades, large-scale reorganizations, deep troubles in the management), and a few were not worth the trouble.[9] Similarly, in the Netherlands between 1968 and the first half of 1970, major acquisitions occurred which involved such leading companies as Shell Oil, Philips, Akzo, Heineken, and the primary shipbuilding, transport, construction, and food product firms. Of the fourteen major mergers and acquisitions, five can be rated successful (the combination still exists and has been profitable), seven were failures (the combination has gone broke and has disappeared altogether, was dismantled, or the acquisition was later sold because of disappointing results), and while two of the merged companies have remained intact over the twenty years, they barely escaped bankruptcy.[10]

A survey of one hundred West German companies effectuating mergers and takeovers from 1967 to 1981 (focusing on large acquirers) also registered an economic performance of 40-40-20. The study measured the profitability: (1) on total capital; (2) on investment in the takeover; and (3) by a possible write-off on the participation. That is, if all

[8] *See* Greenwald, *Where's the Limit?: The Biggest Takeover Battle in History Raises Questions About Greed, Debt and the Well-Being of American Industry*, TIME, Dec. 5, 1988, at 66; and *$25,000,000,000: Buyout Barons kkR Outfox Ross Johnson's Group and Walk Off with RJR Nabisco, but the Price Comes With a Colossal Debt Load*, TIME Dec. 12, 1988, at 56, concerning Kohlberg Kravis Roberts' recent acquisition of RJR Nabisco.

[9] *See* F. JERVIS, THE ECONOMICS OF MERGERS (1971).

[10] *See* H. DE JONG, *supra* note 6.

three indicators were unanimous and pointed towards a positive or negative outcome, they were rated as "success" (38%) or "failure" (39%). If the indicators showed diverging results, the performance was rated "mixed" (23%).[11]

An important difference between continental European countries like West Germany, Switzerland, the Netherlands, Italy, and the Scandinavian countries, and Anglo-Saxon countries, is the practical non-existence of successful hostile takeover bids and the promotion of mergers by merchant banks and company brokers as a business. Success or failure of company mergers in Europe is critically dependent upon the cooperation of managers and employees. Resistance may hurt a business venture, sometimes severely.

In view of the foregoing general characteristics of the merger process, what is my response to the article by Adams and Brock?[12] First, their crusade against the "bigness mystique," cultivated by businessmen, by many governments, and by substantial public opinion, is well taken. There is indeed a tendency in the western world to venerate giantism. Ancient Greek mythology offers a vividly painted warning: the Promethean fire brought on earth by the Titan, unleashing the evils of Pandora's box upon mankind. The undisputable facts justify the warnings of political economists against size-oriented economic policies: (1) the economic success of mergers and takeovers is, on average, as good as a coin; (2) the costs in terms of human stress are fairly high (what social-psychologists term "the merger syndrome"); and (3) nationalistic political attitudes are often promoted by, and in turn promote, bigness. It is noteworthy that the examples of failed acquisitions were often *government inspired* mergers and takeovers, or were at least supported by governments. It would be interesting to learn whether the mergers in which governments have played a role were, on average, even less successful than purely private mergers, as I presume they would be. We have as yet no evidence to make such a determination.

Second, if the failure rate of mergers and acquisitions is rather high, the fact remains that about one-half of them did succeed. The characteristics, enumerated above, point towards some general cause, which does not operate continuously, but intermittently. Most probably, this general force is the intensification of competition in the economically relevant world: otherwise the simultaneous increase in merger activity throughout the various continents could not be explained. It is noteworthy that peri-

---

11 W. MÖLLER, THE PERFORMANCE OF COMPANY MERGERS (1983).

12 Adams & Brock, *The Bigness Mystique and the Merger Policy Debate: An International Perspective*, 9 NW. J. INT'L L. & BUS. 1 (1988).

ods of increased merger activity were those in which the share of international trade in the Gross Domestic Product of what are now the Organization for Economic Cooperation and Development ("OECD") countries rose fast, and reached a high level. Those periods were also characterized by relatively strong economic growth with stable price levels. In other words, depressions, periods of war, and inflationary times are not conducive to merger activity: after all, important investment decisions require sufficient faith in the future. Thus, strong and stable economic prospects are the carrot and intensified world competition is the stick which drive the merger waves.

One of the major difficulties in evaluating the merger activity of *private enterprise* is its double-sided nature. On the one hand, it is part of the competitive process of a free market economy. On the other hand, it is risky and speculative, sometimes giving rise to dominant market positions. This two-edged characterization of merger and takeover activity is clearly not applicable to every individual case, but it does seem to pertain to the phenomenon in general.

The inference is that governments are well-advised not to promote the concentration movement by means of direct or indirect measures, such as persuading or compelling firms to join forces or giving preferential fiscal, legal or political treatment to mergers, acquisitions, split-ups or buy-outs. Governments can hardly judge the consequences of their deeds and may well be surprised by unexpected outcomes, as has happened in so many European cases in the past. The main task of a government is to supervise merger movements and block those mergers which may result in a threat to the competitive process. The European Community Commission has proposed exactly that several times during the past fifteen years, but disagreement between Member States has once again prevented progress.

As a third, and final comment, given the desirable restraints mentioned above, I dissent from those commentators who see no good at all in merger waves. In a dynamic economy, mergers and takeovers may serve the goal of restructuring economic activities and, though the failure rate may be high, that is inherent to the freedom of future-oriented economic activity. High failure rates are also known to exist for the introduction of new products and the establishment of new firms, and even, though somewhat lower, for the expansion of business by established firms through internal growth. I would also loathe prohibiting the invention of new phenomena, such as the consummation of mergers by means of new financial or organizational devices.

For example, junk bonds raise many eyebrows, as do management buy-outs and buy-ins. However, such financing devices point towards one prominent aspect of the current merger wave: the combination of the forces of entrepreneurial vision with the risk-bearing finance of bankers to achieve value-creation through restructuring badly managed, or misconceived, large firms. The use of unsecured, high-yield loans to finance risky ventures is an age-old phenomenon. In seventeenth-century Amsterdam, such loans—called "bodemery letters"—were issued to finance ship voyages, on the condition that the shipowner would repay with an "agio" (varying between 10% and 70%, depending upon risk, destination and time) in case of success, but would be absolved of the debt if the voyage failed. In present-day London, financiers continue to seek entrepreneurs to undertake buy-outs or buy-ins, which are about three times as safe as new business ventures.[13] It is true that United States debt-to-equity ratios are much higher than in Europe (9:1, compared to 3 or 4:1), but this may be partly explained by the much faster disposal of unwanted assets—the corporate restructuring—in the United States. Nevertheless, the monetary authorities bear an important responsibility to prevent the development of speculative manias. Furthermore, a case could also be made to abolish or reduce the deduction of interest payments on loan financing for tax purposes, so that mergers or takeovers no longer burden society with transaction costs.

In general, therefore, I view merger movements as a necessary, and even partially valuable, phenomenon of free market economies. Governments, however, (1) should not promote mergers, (2) should prevent competition-killing transactions, and (3) supervise and restrain speculative financing and tax-financed deals. In present-day circumstances, such a program requires that economic policy should increasingly counterbalance the merger trend.

[13] Fin. Times, Aug. 13, 1988, at 23, col. 1, § 3.