Fighting economic nationalism in M&As

Many companies do not consider how countries protect key stakeholders, such as shareholders and workers. **Laurence Capron** and **Mauro Guillén** explain why the issue merits attention

The recent battle over steelmaker Arcelor is a vivid example of how the various stakeholders in a company – shareholders, managers, employees and governments – have come to play a key role in transactions. Mittal's CEO, Lakshmi Mittal, recently admitted that he had learned a great deal from the protracted (and ultimately successful) six-month bid for Arcelor. He described it as a "boxing match", and recognised that "in America, it is just about shareholder value and profits", whereas "in Europe, values, culture and tradition are important". When it comes to M&As, the world is anything but flat.

The Mittal-Arcelor battle inspired an exceptional media frenzy, but it is not an isolated case. In countries such as Germany and Japan, where labour rights are relatively well protected, the rise of an active market for corporate control means an M&A has important consequences, such as a conflict of interests between shareholders and employees during post-acquisition restructuring. By contrast, in countries in which shareholder rights reign supreme, such as the US the UK and Canada, the market for corporate control has become one of the most important ways to re-allocate assets and restructure companies.

Professor Guillén and Professor William Schneper of Florida International University recently studied hostile takeovers in 37 countries, which clearly showed how much national corporate governance traditions matter. They found that between 1988 and 2003, 478 hostile takeover attempts were announced in the US and 273 in the UK, compared with only 19 in France, 18 in Norway, seven in Germany, three each in Japan and Malaysia, and just one in Chile. In other words, fewer takeover attempts occurred in countries with more protective labour rights and in which banks are more likely to own shares in non-financial companies. Takeovers were also less frequent in countries where minority shareholder protection rules, such as one-share-one-vote and cumulative or proportional voting to designate directors to the board, are not standard for corporate governance.

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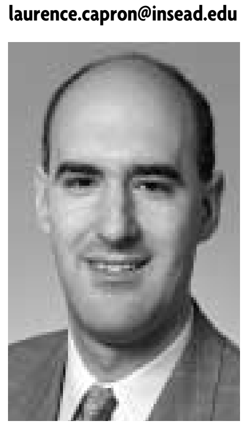

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The particular difficulties of cross-border M&As

Cross-border M&As have always been especially difficult. In 1990, when the Italian tyre manufacturer Pirelli attempted to acquire its German competitor, Continental, the deal faltered, mainly due to a rule in the target's charter that imposed a 5 per cent limit on the voting rights that could be exercised by any one shareholder. After Pirelli and several other allies lobbied investors, Continental's shareholders passed a motion to remove this restriction, but the change was never implemented because of a string of courtroom challenges and appeals filed by both sides of the conflict.

Also in 1990, the well-known takeover specialist, T Boone Pickens, was unable to secure a position on the board of directors of Japan's Koito Manufacturing Company – and potentially initiate an unwelcome corporate reorganisation – despite a 26.3 per cent equity stake. Many observers attributed Mr Pickens's failure to the relatively low sense of fiduciary duty

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that exists between Japanese boards and their shareholders, and to the fact that Japanese managers tend to be evaluated more for their ability to sustain long-term relationships with key stakeholders – major shareholders, workers, suppliers and creditors – than for maximising shareholder returns.

Within the eurozone, after years of market and monetary integration, barriers persist, especially in the services and infrastructure sectors. Even in countries like the UK, where the rules are transparent and outsiders enjoy a relatively level playing field, acquirers often face tremendous scrutiny and criticism from the press. For instance, the announcement by Spanish bank Santander of its intention to purchase Abbey National of the UK in 2004, triggered an overwhelmingly hostile response from the British press.

The takeover raised a host of thorny issues, compounded by the fact that it was an all-share deal. For starters, some British institutional investors in Abbey could not participate in the swap because they were not authorised to own non-British shares. Many individual investors, meanwhile, were worried that Santander's shares were not traded in London at the time. Moreover, British investors were faced with the possibility of income, capital gains and inheritance tax liabilities in Spain as well as the UK.

It is revealing, however, that Spanish companies such as Santander, Ferrovial and Telefónica have so far conducted their major cross-border acquisitions in the UK, across a monetary boundary rather than in the eurozone, where the constraints and the remnants of economic nationalism continue to pose more formidable challenges.

Eon, the German energy group, has complained about the conditions imposed by the Spanish regulator regarding its tender offer for Endesa, a Spanish energy company, and the European Commission has sided with the acquirer. The Spanish government, while opposed to the proposed acquisition, has few legal mechanisms at its disposal to derail it. The situation changed again when Spanish construction and energy group Acciona acquired 13.7 per cent of Endesa, further reducing the odds of a foreign takeover.

Meanwhile, in neighbouring France, the government has orchestrated a merger between energy groups Suez and Gaz de France to deter foreign companies from launching takeover bids, a move that has generated criticism across Europe. And both the Spanish and Germans have complained about Italian nationalism when it comes to takeovers of the latter's banks, which are not particularly competitive or well capitalised. The difficulties facing Spanish concession group Abertis in its quest to take over Italy's Autostrade further illustrates the influence of economic nationalism.

It seems that every country in Europe has reason to complain about somebody else's economic nationalism, but not everyone is willing to look in the mirror and recognise their own wrongdoings. In spite of the harmonisation efforts of the European Union, what the Santander-Abbey episode clearly showed was that the playing field for cross-border acquisitions is not level, even when there is no political interference.

Different countries require different approaches

The market for corporate control varies significantly depending on the country. All manner of differences, ranging from governance practices to tax regulations, stand in the way of successful transactions.

For example, in a 2001 study of the political support among MEPs for a more liberal EU takeover directive, Helen Callaghan of Northwestern University and Martin Hopner of the Max Planck Institute for the Study of Societies found strong differences between countries in line with the national variations of market capitalism. Thus, countries that promoted a stakeholder-oriented model of corporate governance, such as Germany or Austria, were more resistant to removing takeover barriers than countries that promoted a shareholder-oriented model of corporate governance, such as the UK or Ireland.

Particularly striking were the marked differences in national levels of support for the directive, with more than 90 per cent of all British delegates voting for it and more than 90 per cent of German delegates voting against it. Indeed, such barriers are likely to persist in the near future, with the 2004 addition of ten new member states from central and eastern Europe whose corporate governance systems rely on bank monitoring rather than on capital markets.

Targeting similar countries

Given these obstacles, potential acquirers are choosing their targets carefully. In general, acquirers prefer to target companies in the countries that are most similar to their own.

Analysing data on over 20,000 deals, Prof Schneper found that cultural distance, foreign policy differences and disparities in labour regulations reduce the number of cross-border M&As. He also concluded that in countries where governments are able to unilaterally intervene in company policy, cross-border deals are less likely. Not surprisingly, companies prefer to avoid such political uncertainties.

While shunning difficult countries is a reasonable strategy in principle, acquirers should not limit their search too strictly to the most shareholder-friendly countries. Indeed, it is in countries with weaker shareholder protection that the most attractive targets are often found. This is because weak shareholder protection means that, from the point of view of the owners, there is ample scope to improve company performance.

In a recent analysis of 253 M&As, we found that when the acquirer was from a country with a strong shareholder rights regime, it was more likely that the target's R&D, manufacturing and sales network would be downsized. This, in turn, ultimately increased the post-acquisition cost efficiency of the deal. Furthermore, such acquirers were likely to be subject to greater pressure to ensure the acquisition delivers results.

Target restructuring

Target restructuring is often seen as an effective way of delivering rapid results to the acquirer's shareholders. General Electric, for example, is considered a serial acquirer that has managed to put pressure on its acquired businesses to deliver quick results. During the 19-year tenure of CEO Jack Welch, the company completed more than 1,000 acquisitions and enjoyed a 62-fold increase in its share price.

Consider the rapid growth of GE Consumer Finance, which has been fuelled by a string of acquisitions. The key elements of its successful integration process include: rapid cost cutting on functions that are centralised by GE, such as telephone customer service; the quick transfer of GE's key competences to the acquired businesses; and the preservation of local commercial skills that are vital for customer retention.

As a result of its ability to restructure and grow acquired companies, the business has been transformed from a one-product, US-only operation into a multi-product organisation spanning 46 countries. It is now the second largest provider of personal loans worldwide and, in 2005, generated 18 per cent of GE's total operating profits.

Labour rights

Shareholder rights, however, are only one part of the story. Many countries with weak shareholder protection have strong labour rights. In such markets, post-acquisition restructuring to further the interests of shareholders might be more difficult to implement.

In Germany, Belgium, the Netherlands and Greece, for example, the acquirer needs to examine carefully the balance of power between shareholders and employees to determine whether post-acquisition restructuring can actually produce the expected gains. In other words, can a target that

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promises strong future performance be restructured to fulfil its potential, even if it means going against the will of other stakeholders?

An example of the importance of assessing the strength of the workforce is Nestlé's 1992 acquisition of Perrier for $2.7bn, which continues to be the least profitable of its bottled water brands. More than 90 per cent of Perrier's workforce is affiliated with the CGT, a powerful French trade union which has fiercely opposed job cuts and other restructuring measures, even in the face of pressure from the French government.

Andy Martin/Inkshed

This trend indicates that worker power cannot be ignored. In our study of the 253 M&As, we found that the better protected the rights of the target company's employees, the less likely the target's R&D, manufacturing or sales networks will be downsized. Similarly, the target is less likely to receive resource transfers of technology, marketing or management from the acquirer during the post-acquisition process. Perhaps as a consequence of these effects, our data indicate that the better protected the rights of the employees in the target country, the worse the post-acquisition performance in terms of market share, sales and cost efficiency.

The packaging industry, for example, is a sector that has been consolidating over the past two decades. Companies had built large plants to take advantage of economies of scale, but the decision of customers to reduce the number of packaging suppliers left plants running underutilised.

One US company, Crown Cork & Seal, acquired competitors, shut down underutilised plants and switched production to other sites to realise lower unit costs. The company was then able to access their target's customers while lowering overhead and unit production costs. But while such an aggressive turnaround strategy was effective with US-based acquisitions, such as Continental Can, the company encountered institutional hurdles when integrating CarnauldMetalbox, whose main operations were in Europe. The key challenge was dealing with the regulatory and operating environments in Europe. Thus, the company had a difficult time reducing CarnauldMetalbox's selling, general and administrative expenses because of the strength of labour legislation and the heterogeneity of packaging in Europe.

Conclusions

Concluding a deal is only the first step in what can be a long and difficult post-acquisition process of reorganisation and restructuring. Despite the Arcelor success, Mr Mittal's "learning" journey in Europe is far from over. In the US, where labour is relatively powerless, Mr Mittal did not face serious problems after acquiring Inland Steel in 1998 and Bethlehem Steel in 2005.

Continental Europe, however, is a different story. Mittal is likely to have serious problems when it comes to integrating, reorganising, restructuring and re-allocating resources across the various sites of Arcelor, itself the result of a difficult merger of steel companies across several countries.

Our message is straightforward. As Nobel laureate Paul Samuelson famously put it in his book, *Economics*, M&As are "one of nature's methods of eliminating deadwood in the struggle for survival". It is important to understand, however, that power processes drive the selection of takeover targets, the likelihood of a deal being completed and the post-acquisition process of restructuring.

In the short term, the probability of a conflict of interests between the new shareholders and the employees of the target company is high. Therefore, an acquirer must assess the strength of the various stakeholders in order to understand how the process might ultimately unfold.

Given the national differences in the extent to which stakeholder rights are protected, where you acquire may end up being as important a consideration as what you acquire.

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