A LONG-TERM FOCUS FOR CORPORATE BRITAIN
Call for Evidence Response Form

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Please tick the box from the following list of options that best describes you:

	Quoted company
	Other company
	Investor or investment manager
	Business representative organisation
	Investor representative organisation
	Non governmental organisation (NGO)
	Trade Union
	Lawyer or accountant
Y	Other (e.g. consultant or private individual)

Takeovers

Question 15: Do boards understand the long-term implications of takeovers, and communicate the long-term implications of bids effectively?

Comments

They try. All takeover bids are justified to shareholders in terms of their impact on long-term competitive advantage.

The problem is that they often get it wrong.

Frequently they find they have overestimated the synergies to be gained from the takeover, especially where synergies come more in the form of revenue enhancement than cost savings. Sometimes, they fail to assess the extent of

the liabilities on the target's books.

All this can be addressed through more rigorous due diligence. The best companies undertake extensive due diligence, externally sourced – and they abide by the findings.

More frequently, they simply overpay. It is very easy to get carried away in a takeover process. Once you have set your sights, the closer you get to the end-game the more determined you are to complete the takeover.

All this is human nature. It is the essence of capitalism. It requires no further regulation. If the directors get it wrong, as in the case of Lloyds/HBOS, they merit dismissal.

Question 16: Should the shareholders of an acquiring company in all cases be invited to vote on takeover bids, and what would be the benefits and costs of this?

Comments

If the enterprise value of the target is at least one half that of the acquirer, shareholders of the acquirer should be able to vote. They need to be reassured that the directors are not on the verge of thoroughly destroying shareholder value, as in the case of Lloyds/HBOS. For smaller transactions, the board should be permitted to get on with it, as of now.

Question 17: Do you have any further comments on issues related to this consultation?

Comments

There has been much loose talk on the evils of takeovers in recent months. Here I want firstly to slay some myths and then make three policy recommendations, concerning:

i. Companies of strategic interest to the UK
ii. Reciprocal rights
iii. Tax deductibility of interest in highly leveraged companies

Myth #1: M&A destroys shareholder value
Numerous studies over the last thirty years have shown the same thing. In the majority of cases (typically 50-60% of transactions), the shareholder value of the acquirer falls following the acquisition.

These clear-cut results reflect the fact that the acquirer has overpaid –

typically due to the reasons stated above, whether through inadequate due diligence or the rush of blood inherent to the deal process.

But these studies are premised on a huge *ceteris paribus*. In reality, all share prices are lifted by the prospect of takeover. Without the possibility of takeover, whether friendly or hostile, companies become slack – over-staffed, management over-paid, the company slow to innovate. Look at the former building societies and pre-privatisation state-run enterprises. Look at the AA pre-takeover by private equity.

The studies imply that there should be improved due diligence in takeovers, not that the takeover process should be made more onerous. But improved due diligence is not a matter for regulation. It is up to shareholders to demand that of their directors.

Myth #2: There should be a public interest test, to avoid another Kraft/Cadbury

The hype around Kraft/Cadbury was misplaced. Cadbury is of no strategic interest to the UK. It makes chocolate! It operates in a sector where barriers to entry are low and consumers have plenty of alternative suppliers should pricing be abused post-merger.

The debate was emotional, irrational and, understandably, political. Sure, the large Cadbury workforce would be rationalised and that would be painful for some communities, as for any community subject to industry rationalisation and plant closure. R&D may well be relocated offshore over time, as happened with Rowntree. But that is the dynamic of capitalism.

And the boot is often on the other foot. It raises issues little different from those pertaining to Cadbury's own takeovers, eg of Green & Black's, the Turkish Intergum, Snapple in the US.

When BP acquired Amoco in the 1980s, I do not recall these same voices expressing concern for the future of Amoco employees at US HQ and R&D.

If Cadbury were <u>of strategic interest</u> to the UK, that would be a different matter – see later.

Myth #3: Today's takeovers are decided by hedge funds

Hedge funds have as much right to buy and sell shares as any other investor. It is irrelevant if 30% of the Cadbury shares were owned by hedge funds upon deal completion. Former investors who sold out to hedge funds had <u>already</u> expressed their voting intention.

Myth #4: Our liberal M&A climate discourages long-term strategic investment

This is an attractive argument, which goes like this: directors are reticent to embark on Honda-style investment in developing new products and markets if breakeven is ten years or more distant. They are more worried about the next half year's financial results. And if results are dampened for a number of years due to ambitious long-term investment plans, the company becomes prone to takeover.

The trouble is that there is no empirical evidence to support this view. There is plenty of evidence to show that the stock market prices efficiently and will take into account both the short and long term prospects of a company.

Proponents point to the long term investment success of the likes of BMW in Germany or Toyota in Japan – both relatively immune from takeover in their more protected domestic stock markets.

But what of the dynamism of the US economy? What of the long term competitive dominance of Microsoft, Apple, Intel, Boeing? These are companies operating in highly competitive, high risk, high technology sectors in the most liberal M&A market in the world.

Myth #5: Private equity takeovers contributed to the financial crisis of 2008-10

Some private equity investments, such as Gala Coral and EMI, saw enterprise value slide below the value of the debt. Equity was wiped out. Private equity backers saw huge write-downs to their funds. Their pension fund and other investors were unhappy. Tough: that is capitalism.

Private equity was a victim of the crisis, not a cause. Its losses have come from falling asset prices and declining demand created by recession, neither of which did private equity contribute to.

With so many secondary buyouts now taking place, the losers were those still holding the parcel when the markets collapsed. Again, tough: that is capitalism.

There are those that say that the high degree of gearing in private equity transactions contributes to instability. This is true only superficially: the losers are the investors themselves, and possibly the lenders. They may squeal, like Hicks and Gillett, former owners of a highly leveraged Liverpool FC, but they know the rules of the game. The winners are the buyers of the now cheaper assets, like Liverpool's new owner, John Henry. Employees and managers, or football players, carry on as before.

Myth #6: Private equity should face restrictions on the degree of leverage deployed in a transaction

This is none of Government's business. It is the job of the banks. That is precisely what they are set up to do. If they get it wrong, and they do so in

cycles, so be it. Again, that is capitalism. Those responsible should be dismissed.

But the mistakes should not be able to bring down the banks, to the detriment of the depositor. This is where capital adequacy monitoring of the bank as a whole is critical and where regulation certainly does have a role, as in the Basel accords.

These are the myths. But there are three areas where the M&A market can be improved for the benefit of the economy.

Recommendation #1: There should be a public interest test in takeovers involving companies of strategic interest to the UK
Cadbury is not strategic to the UK. BAe is. Between these two extremes lie areas of varying shades of grey. Our power generation and distribution companies are largely foreign-owned, but are they strategic? What of the recent sale to a Canadian private equity house of Tomkins, one of our largest engineering companies? And the formerly inviolate British Steel, later Corus, now in the hands of Indian giant, Tata? What of our investment banks, now virtually all foreign-owned? Is Glaxo Smithkline strategic?

The main problem with foreign ownership comes in the eventual transfer of R&D activities to the foreign-located HQ. Over time, this will lead to fewer such jobs available to British graduates. This is worrying.

Companies of strategic interest to the UK need to be specified by the Government. Defence-related companies should clearly be included – even in the US Government takes care to protect companies like Northrop Grumman. Others need further consideration and definition.

Protection could either take the form of a “golden share”, as for BAe and Rolls Royce of old, or in a ceiling of e.g. 49.5% foreign ownership.

Recommendation #2: Reciprocal rights should be demanded
One of the most distasteful aspects of the furore over the Kraft takeover of Cadbury was the hypocrisy. British companies have a long history of acquiring US companies – viz BP-Amoco, Glaxo-SmithKline, Diageo (Grand Met)-Heublein & Pillsbury. Why shouldn’t US companies acquire ours likewise?

The argument was different when Nestle bought Rowntree Mackintosh in 1989. Nestle is a Swiss company, largely immune from takeover. Swiss companies to this day can deploy a range of measures to protect themselves against hostile takeover.

Other countries like France and Germany used to have similar protectionist

measures, but these have been much eroded over time under EU single internal market legislation. Even the Luxembourger/Spanish/French steelmaker Arcelor was unable ultimately to resist the hostile advances of Indian giant, Mittal.

There is a strong argument that companies from countries which retain protectionist procedures against takeover should be deterred from hostile takeovers in the EU until they liberalise their own markets.

Recommendation #3: Interest payments on highly leveraged companies should be only partially tax-deductible

There is something not quite right about a company making a healthy operating profit, but negative net profit, hence no corporation tax, due to huge interest payments on its high leverage. Why should one form of finance get preferable treatment over the other? – dividend payments are not tax deductible. It also raises the question of why Government should be boosting returns to shareholders by lessening the financial pain caused by excessive leverage.

The problem with curtailing the tax deductibility of interest payments comes with defining what is "excessive leverage". Companies operating in less cyclical sectors (e.g. food) can withstand greater levels of debt than those in others (e.g capital goods, construction).

Here is one approach:

- In private equity transactions; where the value of the debt exceeds <u>one third</u> of the enterprise value (i.e. the value of the debt plus the value of the equity), interest payments on the excess debt (i.e. that above one third of the enterprise value) are not tax deductible for a three year period post-transaction
- For private companies (where the market value of equity is difficult to assess); where the value of the debt exceeds <u>one half</u> of the "book" enterprise value (i.e. the value of the debt plus the value of the equity as determined by net asset value), interest payments on the excess debt (i.e. above two fifths of the enterprise value) are not tax deductible
- For publicly quoted companies; where the value of the debt exceeds <u>one third</u> of the enterprise value (i.e. the value of the debt plus the value of the equity as determined by market capitalisation), interest payments on the excess debt (i.e. above one third of the enterprise value) are not tax deductible

This approach could be made more sophisticated by varying the debt ceilings according to the cyclicality of the sector. Data on the sector beta, a measure of stock market volatility, is readily available from London Business School. Companies operating in low beta sectors, such as food, could have a debt ceiling ten percentage points higher than as shown above, while those in high beta sectors, such as real estate, would have a debt ceiling ten percentage

points lower than as shown above. Companies with a beta of 1.0 would have debt ceilings as shown above. Others would have a debt ceiling adjusted pro rata, with ceilings of private companies determined via a relatively straightforward annual tussle between the company's auditors and the Inland Revenue.

This treatment of tax deductibility on interest payments would not eradicate the use of excess leverage, but at least the tax system would no longer be actively encouraging and subsidising it.