

## Hostile Takeovers in the UK and Short-termism

The need for an anti-takeover law

*John Hann*

In his book *Transforming the Market*, which was reviewed in Ideas for Economic Growth 9, Patrick Diamond linked the decline of the manufacturing sector, and consequently of the regions of the UK, with the excessively 'shareholder-centric' business model.

He pointed out that shareholders in the UK enjoy unusual levels of power, due to their ability to push through hostile takeovers, even when compared with the USA. He argued for more of a stakeholder approach, suggesting that, while retaining the characteristics of the 'Anglo-American' model, the UK should move towards the more long-term German approach.

I would argue that Britain needs to introduce an anti-takeover law to bring Britain at least into line with the USA.

In most of the world, hostile takeovers are rare or almost unknown. Britain is alone in its belief in the benefit of hostile takeovers, a belief which is not supported by the evidence of its large current account and budget deficits.

In 2013 the current account deficit was 4.4 per cent of GDP; the budget deficit was 5.8 per cent of GDP. Britain imported £297bn and exported only £231bn of manufactured goods. Productivity is 21 per cent below the average for the other six members of the G7.

Manufacturing output continues to fall (gross value added fell from 18.7 per cent of the economy in 1997 to 10.1 per cent in 2012); manufacturing employment continues to fall (from 21.5 per cent in 1982 to 7.8 per cent in 2012); and investment in manufacturing has continued to fall as a proportion of business investment (from 22 per cent in 1997 to 11 per cent in 2012).

These statistics are despite the fact that quantitative easing at its peak may have increased real GDP by 2.5 per cent. It is also estimated that just 40 per cent of components by value of British-made cars are now UK sourced.

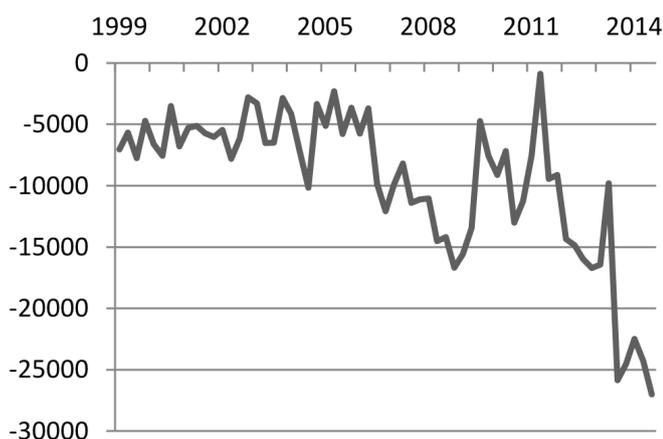
Simon Deakin (2013) wrote that Britain does not have 'a substantial segment of enduring, middle-sized, family-run manufacturing firms such as the German "Mittelstand"'. This is linked to the relatively high incidence of merger and acquisition activity in the UK.'

### ■ The UK as a 'post-industrial economy'

Britain is not, as has often been written, a 'post-industrial economy'. It is an economy which has foolishly allowed financialisation to decimate its industry.

As the Deputy Prime Minister wrote in a press release: 'From the big bang right until what was a monumental crash, the Labour and Conservative governments of the day were so bewitched by London's financial services that they squandered other

UK Current Account £ Million



industries and allowed other communities to wither.’

The desirability of hostile takeovers has been debated in the House of Commons no less than 79 times since the 1950s. In 1954 the chancellor R.A. Butler described them as an ‘adventure of an antisocial type with a view to speculative profit for one’s own personal self without proper regard for the company’; while in the same debate Roy Jenkins explained that ‘companies exist for a great number of reasons other than that of making profits for shareholders’.

Helen Callaghan (2013) has argued that resistance has dwindled as the newsworthiness of takeovers has declined, as the number of beneficiaries in the financial sector has increased (becoming increasingly influential), and as the number of surviving stake-holder manufacturing companies has declined (leaving few voices to protest).

This is reflected in the lack of experience in the manufacturing sector in Westminster and Whitehall. This contrasts sharply with experience in the financial sector. It has been calculated that 16 per cent of the House of Lords have direct financial links with financial services firms; and that on Lords committees scrutinising the budget in 2011, peers who were paid by finance firms formed the majority.

Remarkably, considering that his department believes that no new regulation is needed, the Business Minister Vince Cable has on a number of occasions criticised the current model. He has suggested that hostile takeovers have a deleterious effect on the economy, and that the financial sector, particularly the banks, are too dominant and too easily assumed to be in the national interest.

## ■ The confusion about free markets

Britain is alone in extending the idea of a free market in goods and services to a free market in companies. This has led to the (valid) ‘protectionist’ argument about free trade being extended to an (invalid) argument about hostile takeovers. Britain is in effect suggesting that it is right and the rest of the world is wrong.

As David Green has written, it is important not to confuse support for a market economy itself with support for the particular legal institutions which have come down to us. Criticising hostile takeovers is not anti-business and does not reveal hostility to free enterprise.

The most damaging effect of hostile takeovers is that they cause short-termism. The constant threat of

hostile takeovers compels public companies to take short-term measures in order to satisfy their shareholders. As Cosh, Hughes & Singh (1990) explained, they have shortened the corporate time horizon and raised the target rate of return on investments.

The USA is, by any standards, a free market economy. However, unlike Britain, they responded to the explosion of takeover activity 30 years ago by introducing state anti-takeover statutes, with court rulings which supported defences including the use of poison pills (a mechanism whereby more shares are made available at a discount to other shareholders if one particular shareholder buys more than a certain percentage of shares).

As a result, the state of Delaware (where the use of poison pills has been upheld in the courts) has become a popular place for American companies to incorporate. This includes Rupert Murdoch’s News Corporation which has itself made use of poison pill defences.

In Europe, unlike in the Anglo-Saxon economies, companies are protected by the fact that ownership is often concentrated. There has also been lengthy resistance to takeovers. The European Takeover Directive was resisted for thirty years, culminating in a defeat in the EU parliament. A neutralised version was finally passed in 2003.

In Germany the takeover of Mannesmann by Vodafone caused great concern. This led to the introduction of the WpÜG takeover law, which importantly is not self-regulatory. This means that takeovers can be, and are, challenged in court. In addition German companies are protected by the two-tier board structure. The supervisory boards which include employees and former directors are able to exert great influence in discouraging takeovers.

In France and the Nordic countries, multiple or weighted voting discourages takeover activity. In April 2014 France enacted a ‘Law to recapture the real economy’ which, among other measures, automatically attributes double voting rights for shares held for at least two years, abandons the board neutrality principal during offer periods, and reinforces the powers of works councils in target companies.

## ■ The Kay Review

There have been numerous investigations into this matter. The latest, the Kay Review, concluded ‘that short-termism is a problem in UK equity markets’ and that ‘UK equity markets are no longer a significant source of funding for new investment in UK companies’.

The Review was summarised in *The Economist*

(28 July 2012): ‘The stockmarket exists to provide companies with equity capital and to give savers a stake in economic growth. Over time that simple truth has been forgotten... Having magisterially analysed the problem, the report is rather disappointing when it comes to solutions. One’s heart sinks at Mr Kay’s emphasis on codes of practice.’ The emphasis on codes of practice was hardly surprising considering that, in a tactic worthy of Sir Humphrey Appleby, the advisory board consisted of just three senior city figures.

A similar tactic was employed on the Company Law Review, which led to the Companies Act (2006). In Collison *et al.* (2011) criticisms of this review included suggestions that the participants were selected to recommend no change; that the steering group was not representative of the stakeholder perspective; and that the question of whose interests the companies were operated in was never seriously discussed.

The UK takeover code is principally concerned with the interests of shareholders. Although it has a statutory underpinning, it is essentially self-regulated. The government cannot influence its decisions. The Panel on Takeovers and Mergers (responsible for applying the code) is an independent body with its own code committee made up of a selection of former chief executives, lawyers, hedge funds and bankers.

Cosh, Hughes & Singh (1990) commented that Lord Alexander, the then chairman of the takeover panel, took great pride in the fact that the Takeover Code led to a speedy conduct of takeovers. However this fast pace was, and is, regarded by many as a vice rather than a virtue, and it was suggested by Professor James Tobin, in a notable phrase, that it would be useful to ‘throw some sand’ into the takeover mechanism.

### Foreign direct investment

There appears to be some confusion with regards to foreign direct investment.

Britain has run a current account deficit every year since 1984, a deficit which is now increasing steeply. As a result, we either have to take on increasing debt, or continue to sell our assets abroad.

There will be a limit to how long we can continue to sell British companies and properties. At some point foreign investors will doubt our ability to repay our debt, and may consequently also lose enthusiasm for our property. While the latter would help those wishing to buy a home, it would have unfortunate consequences for the banks, whose

enthusiasm for lending on property is only matched by their unwillingness to lend to businesses.

As Vince Cable said in 2011, Britain ‘was operating a model that failed... a model based on consumer spending, a housing bubble, [and] an overweight banking system – three banks, each of them with a balance sheet larger than the British economy’.

There appears to be an unfortunate confusion in the BIS. They seem to be unable to distinguish between investment in new factories and plant as performed by Nissan and Honda, and hostile takeovers, for example by Kraft and Pfizer. These are not investment as such but are simply a change of owners which, particularly if they are competitors, may ultimately lead to the relocation of production.

Looking at the statistics, it seems clear that any benefit from foreign investment is outweighed by the short-termism caused when public companies are constantly under threat of hostile takeover.

### The effects on companies of hostile takeovers

According to C.V.J. Simpson (2014): ‘Studies of the impact of mergers and acquisitions demonstrate that in the majority of cases it results in a reduction in shareholder value; but this evidence is consistently ignored by the financial community, because it is contrary to their objective of maintaining and indeed increasing their fees from M&A activities.’

And as Vince Cable has said, in replying to a parliamentary committee: ‘There is a lot of research that tends to show that, probably on balance, it reduces shareholder value, quite apart from any social consequences.’

Cosh, Hughes & Singh (1990) suggested that a large relatively unprofitable company has a much greater chance of being immune from takeover than a much more profitable but smaller company. And Franks & Mayer (1996) found that there is little evidence of poor performance prior to bids, suggesting that hostile takeovers do not perform a disciplinary role.

Cosh & Hughes (2008) endorsed the conclusion of Singh (1975, p.954) that: ‘insofar as the neoclassical postulate of profit maximisation relies on a doctrine of economic natural selection of the capital market (via the takeover mechanism), the empirical base for it is very weak’.

According to C.V. J. Simpson (2014), the

finance sector in the UK exercises a particularly malign influence on manufacturing by engaging in leveraged buy-outs. This involves using loans to purchase another company, using the assets of the company being acquired as collateral. The usual consequence is that the acquired company is stripped of its assets (a process called making the capital work harder), which burdens it with debt while the cash is drained out of the company.

In 1985 Mrs Thatcher asked the Department of Trade and Industry to look at leveraged takeovers. It carried out a review of the 'broad relationship between the City and industry' including short-term pressures on management from shareholders.

## ■ Concluding remarks

Wealth is not 'trickling down' from the wealthy financial sector in London to the rest of society. Or if it does, then this is outweighed by the adverse effects of its operations.

The problem of rising inequality in Britain, exemplified by the protests and the occupy movement, has not gone away. It has merely been postponed by allowing Britain to live beyond its means. The inequality between London and the rest of the country is apparent in the increasing demands for regional autonomy.

In the wake of Pfizer's attempted takeover of AstraZeneca, Vince Cable suggested re-introducing a public interest test, abolished in 2002 (when it was restricted to certain industries). This is a distraction. The problem has not suddenly re-emerged since 2002, and the test would in any case only apply to certain companies, as EU public interest rules restrict the ability of the government to intervene.

There is no need for the government to intervene in individual takeovers. What it needs to do is to give all public companies a reasonable chance to defend themselves.

Britain cannot continue to commission yet further inquiries into this matter. The government has to make the decision urgently to introduce an anti-takeover law to bring Britain at least into line with the USA.

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*As a result, he has been in a position to observe about 90% of UK manufacturing (as opposed to assembly) disappear.*

*In his view, a major change occurred about 35 years ago. Before then public companies generally built up reserves and assets, and invested heavily in research and development. However, increasingly after that time any public company that tried this became a prime target for takeover and asset stripping.*

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