ECONOMIC NOTES

TAKEOVERS AND MERGERS - THE ECONOMIC ARGUMENTS

Terry Flew

The 1980s Takeover Boom

One of the most important features of the Australian economy in the 1980s has been the dramatic growth in corporate takeover activity. As Table 1 below shows, there has been a substantial increase in the value of assets involved in mergers and takeovers. This is perhaps best symbolised by the attempted takeover of Australia's largest corporation, BHP, by Robert Holmes A'Court's Bell Group, in which all 3 parties involved spent over $8.5 billion over a five year period.

Table 1, VALUE OF ASSETS INVOLVED IN TAKEOVERS

	Number of Takeovers	Value of Assets ($m)
1976-79(av)	180	831
1980	192	2696
1981	206	3242
1982	174	2207
1983	132	2845
1984	142	7879
1985	140	4297
1986	142	4766
1987	205	8540

Sources: Reserve Bank, Company Finance, August 1986; D. Clark, "The Economics of Takeovers and Mergers" Student Economics Briefs 1988-1989 (Financial Review Library, 1988).

This takeover boom has not been peculiar to Australia: it has also occurred on a large scale in New Zealand, Canada, Great Britain and, most notably, the United States.[1] While there has also been significant takeover activity in Japan and the Western European economies, it has not been ofa comparable magnitude. This raises the questions of why this boom has occurred in economies such as Australia and not in other comparable economies, and whether its overall impact has been positive or negative.

Reasons for the Takeover Boom

The standard economic literature identifies a number of reasons why one corporation would seek to acquire another. Where both the acquiring and acquired firms are in the same industry or a related one (eg. a supplier of inputs or a customer)[2] the motives are generally to boost profits by reducing costs through realising economies of scale, or to reduce competition in the industry thus enabling the charging of higher prices. Most forms of state regulation of takeovers have sought to promote takeovers and mergers which achieve the former objective, while discouraging or preventing those where the latter motive predominates.[3]

A very large number of takeovers in recent years have been between corporations in quite unrelated industries, as shown by the vast range of activities in which the so-called 'entrepreneurial investors' (or 'corporate raiders') have been involved. These takeovers may be motivated by a desire to reduce risks through diversification, a belief that the target firm is performing below its optimal level and hence is undervalued on the share market, a desire by management for growth for its own sake, realisation of short-term capital gains, or solely for purposes of tax minimisation (see McDougall and Round, 1986: 42-46).

1 In the US between 1977 and 1986 there was $US 389bn worth of takeovers and merger business, involving the takeover of over 23,000 companies. 1988 saw $US282.4bn ($A325 bn approx) involved in takeovers, while in 1989 the management of RJR Nabisco completed a buying-back of all shares in the company for $US20.9bn ($A25 bn approx) in the largest business transaction in history.

2 The former case is termed horizontal integration, whereas the latter is called vertical integration.

3 Whether the net effects are to enhance efficiency or reduce competition can be determined by the effect of the takeover on prices and output of the newly-merged entity (McDougall and Round 1986:53-56).

Most academic research is directed toward assessing the goals and the outcomes of takeovers and mergers on a case-by-case basis: but the more interesting and relevant question is why such a boom in takeover activity has taken place in Australia in recent years?

Three reasons suggest themselves. *First*, deregulation of the Australian financial system has greatly increased the availability of credit (especially from overseas) as well as sharply boosting the rate of return on financial assets, both absolutely and in relation to rates of return in other sectors. *Second*, the corporate taxation system in Australia has promoted takeovers which are financed through debt, particularly since interest repayments are tax-deductible, whereas prior to 1987 dividend payments were taxed twice, as corporate profits and as a receipt of income by shareholders. It is certainly no coincidence that those firms most actively involved in takeovers also tend to possess the highest debts and pay very low rates of company tax . *Third*, the Hawke Government has largely adopted a 'laissez-faire' approach to corporate takeovers, and at times (particularly in relation to the 1987 media takeovers) made legislative changes which positively promoted takeover activity.

For some, this takeover boom simply indicates a healthy and vigorous capitalist economy at work. Corporate managers are forced to 'shape up or ship out' under the threat of a hostile takeover; and the 'market for corporate control' guarantees the most efficient use of resources by corporations, hence maximising returns for their shareholders.

Other writers have argued that few efficiency gains have resulted from the takeover boom, and that it is symptomatic of an alarming shift away from productive investment and strategic planning towards purely speculative 'paper shuffling' activities (Stilwell 1988). They see the 1987 stock market crash as being a warning of the dangers arising out of this short-term orientation.

Pro-Takeover Arguments

The pro-takeover argument has been put by the Department of Treasury and in various papers put out by the right-wing Centre for Independent Studies (Treasury, 1986; Dodd and Officer, 1986; Bishop, Dodd and

Officer, 1987; CIS, 1987). Their case for takeovers can be summed up in three points:-

1. Takeovers are essential for economic efficiency. In its paper *Some Economic Implications of Takeovers* (1986), Treasury argues that takeovers promote three types of efficiency:

> i) allocative efficiency - they allow capital to be shifted between industries through the share market to its most profitable uses;
>
> ii) operational efficiency - existing corporate assets can be used more effectively by a new team of corporate managers;
>
> iii) dynamic efficiency - corporate managers are forced to improve their firm's performance under threat of takeover.

2.The benefits of takeovers can be measured through share market gains. The CIS studies claim that, if the share price of both the acquiring and acquired firms increase with a takeover, this is prima facie evidence of improved efficiency which is attributed to a process called 'synergy'. On this basis Bishop, Dodd and Officer (1987) found that takeovers in the 1974-84 period boosted share market values by $7.2 billion, and that this constituted an equivalent increase in Australia's net wealth.

3.The only desirable role for government in regulating takeovers is to ensure 'fair play' in their conduct, ie equality of treatment for shareholders by requiring bids to be equally available to all and not simply the largest holders, and provision of adequate information to all shareholders by the bidding company.

The alleged efficiency gains arising from takeovers have been questioned in the major study by McDougall and Round (1986) already cited, jointly commissioned by the National Companies and Securities Commission and the Victorian branch of the Australian Institute of Management. Their study found that acquiring firms made few improvements in the post-takeover period in terms of growth, higher profits or reduced risk. This was true whether the results were compared to their pre-takeover performance or to the performance of comparable firms not involved in takeovers. The study found that the major beneficiaries were shareholders in the target firm, and this result is confirmed by overseas studies (eg Mueller, 1980). Ironically, existing takeover regulation administered

through the NCSC is mostly designed to protect the interests of this latter group.[4]

The use of share market prices to measure the effects of takeovers must also be seriously questioned. Shares constitute a form of 'fictitious' capital whose value generally differs from that of the 'real' assets of the corporations concerned, and whose prices fluctuate on the basis of factors often far removed from actual corporate performance. The claim that wealth in the form of share capital is synonymous with real wealth begs the question of how over $25 billion could disappear from Australian share markets in a week with the 1987 share market crash with only a minimal impact on production and employment. It also raises the question of why it happened: was there a massive breakdown in synergy? Did everyone simply need a holiday? [5]

To the extent that takeovers have boosted profits, the question which remains is whether this is due to increased efficiency or to reduced competition in an industry, in which case the remaining competitors are able to charge higher prices to consumers. In industries such as airlines, retailing and the media, recent takeovers have dramatically reduced the number of competitors. In retailing in 1987 the top 20 retailers held over 44% of sales, compared with the top 25 in 1983 having 34% of sales. With the merger of Myer with Coles in 1984 and of Woolworths and Safeway in 1985, the two resulting retailing giants control almost one-third of the total retail sector. Other takeovers, such as the takeover of the Herald & Weekly Times by Rupert Murdoch's News Corporation, and the merging of Ansett and East-West, have had even more alarming effects upon competition in the newspaper and domestic airline industries respectively.[6]

4 These regulations include the requirement that individuals or corporations acquiring over 20% of shares in another corporation make a formal takeover offer whereby all shareholders in the target company are notified within 14 days of the bid, the rule that a bid is made for not less than 28 days, and restrictions upon the ability to make partial bids (ie where control can be gained with less than 50% of the shares).

5 There are also problems with using (as the McDougall and Round study does) accounting data to measure corporate performance, due to the varying quality of information given by corporations in their Annual Reports.

6 Murdoch's takeover of the Herald & Weekly Times increased his share of the newspaper market from 28% to 61%, with a near-monopoly of sales in three capital cities - Brisbane, Adelaide and Hobart. Needless to say, the implications of this concentration go way beyond economics.

Many respond by arguing that an analysis of competition has to go beyond the restrictive framework of the neo-classical view of market structures (perfect or imperfect competition). Higher concentration of ownership in an industry may not reduce competition if management of one or more of the firms is sufficiently aggressive in its pursuit of market share, or if there is actual or potential competition from overseas producers or from firms providing reasonably close substitute goods or services (eg domestic airlines and interstate coach services, matches and disposable lighters, banks and other financial institutions). In some instances, it is argued, increased concentration may be essential in order to realise economies of scale in the industry or to respond to large overseas competitors.[7]

Anti-Takeover Arguments

Critics of the 1980s takeover boom do not deny that some takeovers have produced efficiency gains, nor that an individual investing in one of the 'corporate raiders' would have (until recently) made a tidy sum of money. They do, however, reject the abstract model-building approach of the pro-takeover theorists and their naive *a priorism* in favour of more detailed empirical analysis. They also suggest the focus should shift from the costs and benefits for shareholders to a focus on what have been termed 'stakeholders' ie those whose welfare is tied up with the performance of a company such as employees, customers, suppliers, taxpayers and governments (eg Kuttner, 1986; The Economist, 1988).

The takeover boom of the 1980s has both increased the interest repayment bills and reduced the tax payments of the corporate sector. Max Walsh has estimated that the largely tax-driven shift to debt financing has reduced the corporate tax base by up to 30% (Walsh, 1987), while Figure 2 below shows how this has been tied up with the growth in interest payments:-

7 Nonetheless, the Trade Practices Act has proved alarmingly ineffective in regulating takeovers in order to maintain competition, and is currently subject to a wide-ranging review by the Griffiths Committee inquiry into mergers, takeovers and monopolies (EPAC, 1989: 18-20).

Table 2, INTEREST PAYMENTS AND TAXATION (as % of gross profits)

	Interest Payments as % of Gross Profit	Taxation as % of Gross Profit
1981	19	25
1982	26	22
1983	28	21
1984	23	22
1985	26	21
1986	27	20

Source: Reserve Bank, Company Finance, page 15.

The takeover boom has also intensified concern with short-run returns on financial assets to the detriment of longer-term investment in new productive capacity. The study of the National Institute of Economic and Industry Research into private investment found that high levels of corporate debt coincided with below-average levels of fixed capital investment (NIEIR, 1986:6), which is not surprising when one considers that interest repayments reduce the share of gross operating surplus available for new investment.[8] The NIEIR study also found that the firms most involved in takeover activity (the corporate raiders) had the most substantial exposure to domestic and foreign debt, limited surplus cash flows to cope with debt repayments should profits diminish, and a tendency to dispose of assets to meet short-term cash flow requirements (so-called 'asset stripping') (NIEIR, 1986:66).

Finally, to the extent that both financial deregulation and the takeover boom have fed off each other to increase private sector overseas borrowing, the takeover boom has worsened Australia's balance of payments deficit. That deficit has of course been the primary justification for cuts in workers' real wages and living standards and for cuts in public sector spending, even if the figures themselves are of dubious accuracy and relevance in an era of internationalised capital accumulation (Bryan, 1989).

8 Many in the steel industry found the prospect of supporting the BHP management in their battle with Holmes A'Court quite a stomach-turning prospect.

Why Does It Matter?

There is an argument, heard in radical as well as conservative circles, that takeovers are a necessary and desirable aspect of capitalist development, as they enhance the productive capacity of the economy over the medium-term even if their short-run effects may be undesirable. Another view, held in some trade union circles, is that 'a boss is a boss' and that workers should not choose between one side or another in battles for control within the capitalist class.[9]

There are many reasons why this view must be questioned in the context of the 1980s takeover boom in Australia. Much recent takeover activity has been solely concerned with a desire to minimize tax or to reduce competition. In both of these cases, the costs of takeover activity are shifted onto workers as taxpayers and/or recipients of government services and as consumers.

As far as national economic performance is concerned, the takeover boom has forced all public companies to display greater concern for short-run share market performance than for strategic planning. The growing interest bill also reduces the share of the investible surplus available to be put into new productive capacity. Considering the historically poor performance of Australian capital with investment in plant and equipment, new technologies and research and development, this is worrying as the takeover boom has only exacerbated this trend.

Perhaps most importantly, the growing interest bill of the corporate sector increases economic instability. For companies with high debt bills such as Bond Corporation, there is a growing pressure to use their productive interests as 'cash cows' to 'milk' in order to finance their debt repayments, particularly if their recourse to creative accounting and overseas tax havens is diminished. The prospect of more and larger public bailouts of over-extended private interests (such as that by the WA Government of Rothwells, or the more recent waiving of $70 million of stamp duty payments owed to the NSW Government by John Fairfax) has also grown in the wake of the stock market crash.

9 Since these companies were until recently the best performers on the stock market, as well as because of increased competition in the financial sector, institutional investors have also become increasingly oriented toward short-term profits (Murrill and Tingle 1986).

Finally, the manifest inadequacy of analyses such as those provided by Treasury points to the need for concerned political economists to more fully incorporate the financial dimensions of capitalist economies into their analyses. This is a necessary first step in enabling us to devise strategies for change so that the 1990s do not become a re-run of the 1930s, which the takeover boom of the 'Roaring '80s' has indeed made possible.

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