What to do about foreign takeovers

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The UK has always held a wide open door to foreign takeovers. In the UK takeover policy is laissez-faire and decisions about takeovers are believed to be for the shareholders alone. When the UK was one of the biggest beasts in global acquisitions the open-door philosophy suited it. However the tide has sharply reversed and since 2004 the inflow of acquisition capital to the UK has significantly exceeded the outflow, providing a poignant case study in the U.K.'s loss of dominance. The data are at the end of this paper.

As a result, whenever a big foreign takeover is in the air there is a recurring debate about whether government should intervene. In the latest episode, in late April 2015, Prime Minister David Cameron made a surprise election promise that he would block any future attempt to take over BP, the British oil major so financially damaged by Macondo. Though there was no bid for BP on the table, there had been speculation that Exxon Mobil might make a move. The next morning, in a perfect expression of shareholder value zealotry, the Financial Times published a piece titled 'BP investors need protecting from Cameron', saying, *BP shareholders have paid for the right to determine the company's future. The government has not. It is Mr Cameron, rather than Jonny Foreigner, who should hop it*.

My purpose in this paper is to examine the arguments. I start by challenging this very British belief in the primacy of shareholder value. It is the job of government to protect the public interest and that is largely about creating and maintaining high wage employment and protecting and nurturing the intangible assets that sustain it. The modern reality is one in which nations are competing against each other for the investment of mobile, rent-seeking transnational businesses. In that world there is no reason at all to expect the pursuit of shareholder value by corporations to coincide with the self-interest of the UK or of any other individual nation.

The concern about foreign takeovers is at its root a concern about 'home bias'. This is the belief that companies have a dominant national allegiance, so that replacing domestic ownership by foreign ownership must reduce domestic investment and employment in the long run. Home bias is a factor in this discussion, but the reality is much more complex. Lift the hood on many national champions and you find much of the assets and many of the employees are already located overseas. Anyhow, many of the U.K.'s most successful industries, including the resurgent automotive industry and the dominant financial services industry, are overwhelmingly foreign-owned, frequently as a result of takeover.

This is the reason you cannot generalise about foreign takeovers. What we want is *good owners*, and it doesn't much matter whether they are foreign or domestic. Good owners take a long-term view and have a commitment to developing domestic employment and to nurture and build the intangible asset base. Tata Motors has turned out to be a good owner – since its acquisition in 2005, Jaguar Land Rover has become one of the world's top performing car companies. In the same way, the reason that that Kraft's takeover of Cadbury and Pfizer's bid for AstraZeneca caused so much anxiety was not that they were foreign but that there was little confidence they would be good owners in this sense.

Without doubt the key to retaining and growing investment and employment is to focus on maintaining the nation's competitive advantage – those features that make a country an attractive place for mobile international capital to invest and where the best managerial talent will want to work. That has to be the main priority of government. But government does need to be willing and able to intervene in foreign takeovers, if needs be. The UK is now almost unique in its unwillingness to do this. The quality of ownership has to be assessed on a case-by-case basis, and this is what government should be looking at. Government needs to have the tools to measure the public interest when required, and I explain what those tools look like in this paper.

Shareholder value versus the public interest

Kraft acquired Cadbury in 2010. Kraft was a not-much-loved US food giant. Cadbury was a UK company with a 135-year history and philanthropic roots. It wasn't bust and didn't apparently need fixing, and it made chocolate, which is the U.K.'s national dish. In true UK fashion, Cadbury's management quickly accepted their fate – their duty was to maximise the wealth of their shareholders. Thoughtful equity analysts lamented the passing of a great business but told shareholders to accept the bid anyway. Government was reluctant to get involved, at least in public.

In this culture, only the shareholders are deemed competent to make these decisions and the only respectable topic for discussion is whether an acquisition will create long-term shareholder value. Now we know from research that corporate acquisitions frequently destroy long-term value for the shareholders, but the thinking is that if we can just cure the corporate short termism that allows these value destroying takeovers, that should do the trick. So despite the fact that the UK already had one of the world's more evolved corporate governance protocols, Kraft/Cadbury turned into an intense debate on short termism, on corporate governance, and on improving the takeover rules to ensure that long-term shareholder value gets delivered.

The tone of the Pfizer/Astra Zeneca debate in 2014 was more pragmatic, with more discussion of the public interest. There was more at stake with Astra Zeneca then there was with Cadbury. But, publicly, political statements followed traditional lines. In the event, resistance by Astra Zeneca's management, the rejection of the bid by at least some of the institutional shareholders, and the exercise of some political soft power in the background were sufficient to see off the bid. So the doctrine of non-intervention survived untested. The changes that had been made to the UK Takeover Code following Cadbury do actually seem to have thrown some more grit into the takeover process because Pfizer eventually ran out of time under the 'put up or shut up' rules.

This focus on corporate governance in the foreign takeover debate is a distraction. Astra Zeneca may have been a good buy for Pfizer. Maybe Kraft overpaid for Cadbury. It would or will take years to find out. But even if an acquisition is in the long-term interests of all the shareholders, it does not follow that it is in the public interest. Shareholder value and the public interest are different things. The long-term interest of the shareholders of an entity is in maximising its profit, after tax, and globally, not domestically. The modern reality is one in which nations with similar resource endowments compete for mobile international capital. In that world there is no reason to expect the pursuit of long-term shareholder value by corporations to coincide with the self-interest of any individual nation.

Let's say that the job of government – the public interest – is to maximise per capita national income subject to some distributional concerns. Assuming national income is roughly two thirds wage and one third profit, then the prime goal is to create and sustain a high wage economy. We get high wage employment from a skilled workforce supported by intangible resources such as R&D assets, skills, intellectual property, organisational competences and know-how. These intangibles confer competitive advantage on nations just as they do on individual businesses.

Perhaps surprisingly, the returns to intangible capital frequently accrue as wage rather than profit. The automotive, aerospace, pharmaceuticals, and financial services industries are all intensive users of intangible capital and they are all high wage employers but only pharma historically generates a rate of profit that is significantly higher than its investors' opportunity cost of capital. In any case, in a world of integrated capital markets and complex ownership, the ultimate domicile of profit is hard to identify. It is pragmatic for government only to count the profit that can be captured through corporate taxes, reinforcing the focus on wage.

Home bias
I use the phrase ‘home bias’ to describe the extent which a company has a national domicile and cultural identity that influences its economic behaviour. The idea of home bias very influential in these discussions, but it is elusive.

The home bias story about foreign takeovers runs as follows:

- Since some head office functions are duplicated, the foreign acquisition of a domestic firm leads to the immediate loss of the domestic head office and of the high-wage employment in the head office and in the head office supply chain.
- Whereas the domestic firm had a bias towards the local economy, loyalties have now changed, at best to neutrality and probably in favour of the acquirer's home economy. So the expected level of domestic investment and employment is lower as a result of the acquisition. If there is a recession or economic downturn, domestic capacity will be particularly vulnerable. When there are jobs to shed, those acquirers have no emotional attachment to the UK. Their ‘home bias’ is elsewhere.
- The home bias story also has an asset-stripping aspect. The assets that can be easiest to unbolt and take away can include the intangibles – particularly the brands, the R&D and the know-how – that underpin high wage employment.
- Corporation tax revenues fall as the foreign acquirer is able to route income to low-tax jurisdictions.

Once upon a time, companies had clear national identities. We could easily identify them as Japanese, German, UK, US companies. If they were listed, they would be listed on their home stock market. The head office would be in the home country and most of the senior personnel would be citizens of that country. In the limit, these companies were effectively agents of the state, like the old English and Dutch East India companies.

But many multinational companies now see themselves as truly global, as transnational and essentially stateless. There may be a legacy element in the company’s legal domicile, but the decision about where to be listed and about the location of the head office is pragmatic and is driven by tax and regulatory considerations. When hiring managers, these companies like to achieve a balance and diversity in the nationality of the workforce and of the management that reflects the national markets they serve.

This stateless, transnational model is one in which international resource allocation decisions are made purely on the basis of cost and profit. When locating plants, the logic is economic and the decision will balance factors such as proximity to markets, input costs, and spreading production risk. That fits with the UK shareholder-value culture, and also accords with the British instinct for a fair game played on a level playing field.

So how important is home bias in practice? Pankaj Ghemawat of IESE reports compelling data about the nationality of CEOs (reported in the Economist, 1st June 2014) which throws at least an indirect light on this. According to Ghemawat, 88% of the CEOs of the Fortune Global 500 and 85% of the senior management team are nationals of the country where the company is headquartered. There is regional variation within the 500. For European companies the percentage is 77% of CEOs (72% of senior managers) and for North American, 89% (87%), while for Japanese companies the percentages 97% (95%)!

The evidence from Ghemawat, supported by casual empiricism, suggests that while there may be a trend towards the transnational model, the model of companies having a national identity remains common and even dominant. Further, economies like the UK now face competition not just from the traditional developed world, but from Asia and Latin America where the rapid accumulation of capital is providing the resources and ambition to become global operators. Much of this capital is accumulating in corporations or investment funds where effective control lies with families or states, rather than being democratised through public capital markets.

However, even if companies do retain a strong national identity, the real question is the extent to which this affects their economic behaviour. Unfortunately this part of the home bias story is tough to prove, it lacks data. In a review of the rather patchy research evidence on the impact of foreign acquisitions on employment I found no direct studies of the influence of home bias on corporate decision-making.

The nation's competitive advantage

Here is a different story about foreign takeovers:

- The domestic economy, and the individuals within it, possess valuable intangible assets. This 'national capital' includes human capital in the form of a skilled workforce, language and quality of life, and legal and institutional structures. The foreign acquirer wants to access and enjoy these things, which is why they came.
- The domestic economy also gives access to a large and valuable regional market. The acquirer perhaps plans to make the domestic economy the location of its regional headquarters. The head office expands.
- As a result, foreign takeover is followed by significant investment and by growth in high value employment, both directly and indirectly through the supply chain.
- Corporate and payroll tax revenues increase.

This would describe the UK's, largely foreign-owned, financial services industry and automotive industry. Indeed it describes all of the U.K.'s most successful industries, whether home-owned or foreign-owned. Bertrand at al (2012) produce some fascinating results on the impact of foreign takeover on domestic R&D investment. They show, both theoretically and using data on the foreign affiliates of Swedish MNEs that foreign acquirers are *more* likely to grow domestic R&D investment than foreign direct investors would be[1].

So you cannot generalise about foreign takeovers. They have to be judged case-by-case. While some foreign takeovers may indeed be a prelude to asset stripping and may lead to depletion in the quality and depth of the domestic economy, other foreign takeovers bring skilled management and a long-term view – 'patient capital', in Will Hutton's phrase – to revitalise failing industries. Just as foreign direct investment brings capital and employment to green fields, these takeovers are a prelude to real investment that creates employment and deepens the capital base.

A notable example is Jaguar Land Rover. After the dismantling of British Leyland, the U.K.'s failing domestic car manufacturer, the Jaguar and Land Rover businesses were bought by Ford and BMW. Neither of these foreign owners succeeded in realising their potential and, in due course, so the want to Tata Motors in 2005. Since then, JLR has been transformed into the world's most profitable, and fast-growing, car manufacturer. The Indian owner appreciated the value of the intangibles it had acquired – the skills, the know-how, the brands. It brought in senior management from BMW and a willingness to make very large financial investments in training and physical plant in the UK. Tata turned out to be a 'good owner'.

Equally, the reason that a takeover of Cadbury by Kraft and of AstraZeneca by Pfizer caused so much anxiety at the time was not so much that the potential acquirers were foreign, but that they were not viewed as good owners. Pfizer had a history of cutting R&D spending in companies that it bought. Following the Cadbury acquisition, Irene Rosenfeld, Kraft's controversial CEO, immediately

[1] See Olivier Bertrand, Katariina Nilsson Hakkala, Pehr-Johan Norbäck and Lars Persson *Should countries block foreign takeovers of R&D champions and promote greenfield entry?,* Canadian Journal of Economics, 2012, Volume 45, 3, pp 1083–1124; also Bertrand, O., *Effects of foreign acquisitions on R&D activity: evidence from firm level data for France*, 2009, Research Policy 38, 1021–31.

reversed a pre-acquisition pledge and closed Cadbury's Bristol plant, then decided to relocate Cadbury's headquarters to Switzerland, outside the reach of UK corporate taxation.

In assessing the impact on national income of a foreign takeover, or of foreign direct investment for that matter, government needs to judge the track record and intentions of the acquirer, and how they will balance the pull between 'home bias' and the locational attractiveness of the domestic economy and its endowment of intangible assets.

In foreign takeovers some specific factors need particular attention. The effective location of the head office is particularly important when thinking about the public interest in foreign takeover. A head office is typically a high-wage productive unit. It also has its own external supply chain in the form of the IT, legal, financial and advisory service companies and so forth that support the head office. Closely related to the location of the head office, is the issue of the domicile of the corporation, and the influence that will have on future resource allocation decisions.

Another issue is taxation. In principle, in the context of social cost benefit analysis, you should ignore the corporation tax consequences of a decision because taxation is a transfer payment that does not affect national income. But if we ignore the profit element of a private evaluation when calculating public benefit, because of the uncertain domicile of the owners, then it is inappropriate to ignore the impact on tax revenues. So we need a clear analysis of the impact of foreign acquisitions on domestic tax revenues.

Competition policy and industrial policy

The tension between intervention and laissez-faire shows up in the uncomfortable relationship between industrial policy and competition policy. Free-market doctrine says that competition policy is all you need, and that industrial policy is redundant. Effective competition between value-maximising agents will deliver efficient resource allocation and will give you the industry you should want.

It is worth noting that for free-market advocates it seems to be acceptable to act systemically but not selectively. You can slope the playing field your way, but should not intervene in the game. In other words, *selective* industrial support is the piece that free-market advocates reject, and they have a deep mistrust of government's ability to pick winners, which should be left to market forces and, in the case of a takeover, to the shareholders. In practice, the distinction between systemic and selective intervention is far from clear, and the tax and regulatory structures that a nation legislates are frequently informed by the needs of particular sectors or activities.

The reality of the modern global economy means that any government would be negligent if it did not have a clear understanding of those sectors and companies that are most likely to deliver national income. All nations do this, and they do everything in their power to support those activities. Even the US no longer has the self-confidence to rely purely on competition policy. Microsoft is one of the US's globally dominant businesses. Twenty years ago there was active talk in the US of breaking up Microsoft in the spirit of anti-trust, and in 2000 a US court (albeit briefly) ruled in favour of the breakup of Microsoft as a remedy. It is hard to imagine that kind of zealotry now.

In practice, and despite its strongly free-market public stance, the UK pursues an active industrial policy on two levels. It strives to maintain an attractive tax and regulatory environment for mobile international capital. Language, institutions, and geographical location are also important assets for the UK, and there is now an intense policy focus on skills and education. But the UK also runs an effective program of selective industrial support. UK officials have a clear understanding of the sectors that are of high value – pharmaceuticals is one of them – and have sophisticated cost-benefit-analysis tools for measuring the national income impact of investment and disinvestment.

A pure focus on competition policy may be justified in economic transition, when you are trying to drive reform into an inflexible and underperforming economy, which was the driver behind the so-called 'Tebbit doctrine' in the UK. Under the 1973 Fair Trading Act, the public interest test for mergers had been broad in scope and, though this was rarely invoked, it allowed the consideration of employment effects. But the Labour government's 2002 Enterprise Act defined a narrower slate of public interest concerns that included national security, media quality, plurality & standards, financial stability, but it excluded employment. Discretion over takeovers was removed from ministers and placed with the competition authorities.

This remains the status quo and, in consequence, merger policy is now out of line with industrial policy. While UK merger policy does have a public interest test, that test is now narrowly drawn to be an instrument of competition policy. That legislative clock won't easily be turned back. European legislation and in particular the EC Merger Regulation (ECMR 139/2004) has the same stern emphasis on competition policy.

A pragmatic case for intervention

The UK's reluctance to police foreign takeovers stems from deep belief that these things should be left to the shareholders. However, this is a belief that appears to be unmatched in any other major economy. An additional problem in the UK is that the ownership structures that protect companies in some other countries are absent in the UK; liberal labour laws make redundancies easier to effect in the UK than in many other jurisdictions; and the very prowess of the U.K.'s financial services industry means that it houses an army of professionals incentivised to facilitate the foreign ownership of UK assets.

With the continuing globalisation of capital markets, all developed economies are seeing increased foreign ownership of their assets and are expressing concern about it. There has been a tangible change in international mood in the last decade, in the direction of protectionism. Most of the U.K.'s competitor nations either have broadened their powers to intervene in foreign takeovers, or are doing so.

As part of its moves to see off a bid for Alstom's energy divisions from the American General Electric, France published a decree on May 15th 2014 requiring foreign buyers to get the approval of the economy ministry for investments in French firms engaged in energy, transport, water, health or telecoms. Originally the decree was limited to national defence but in 2005 France amended the law in order to block takeovers of French companies in 'strategic sectors' – the concern at the time was to defend the French yoghurt maker Danone from a US predator! In practice, the French government prefers to use soft power to stop deals or push them in a different direction.

Anglo-Saxon readers will never be persuaded to view France as a model, so consider the US instead. In the US, the Committee on Foreign Investment in the United States (CFIUS) can block takeovers with implications for national security. In 2006 CFIUS approved the purchase of the UK group P&O by Dubai Ports World, which had implications for the ownership of many US ports, but opponents in Washington were able to amend a senate bill to block the transaction.

German takeover law enables the government to block the ability of a non-EU or EFTA bidder to buy more than 25% of a German company's voting shares on public order or security grounds. It is in any case harder for bidder to gain direct control of the management board of a German company because of the two-tier system. Shareholders directly elect the supervisory board, which is then responsible for appointing the management board.

One argument against intervention is a worry about spoiling the 'open for business' image. Both the US and Canada have a similar public stance to the UK and generally stand back from the market. But they both retain the power to intervene in foreign takeovers and occasionally use it, without any apparent effect on the 'open for business' image. An example is Canada's intervention in 2010 to block BHP Billiton's $39bn bid for Potash Corporation. Canada intervened under its broadly drafted Investment Canada Act, which requires a foreign takeover to bring a ‘net benefit’ to the country in terms of jobs, exports, production and investment.

Some people argue that government intervention is futile because the horse has already bolted – big business is now effectively stateless and is beyond the control of nations, so we just have to live with that. So, for example, big pharma will source and outsource its R&D globally and will make that decision irrespective of the will of national governments. Pfizer and Astra Zeneca were well down that road – Astra Zeneca (with its French CEO, Pfizer had a British CEO) had already shed a lot of UK jobs.

Another argument against public intervention is about trust and competence. Sceptics say that politicians will make political decisions and that officials don’t have the competence to ‘pick winners’. The Potash bid had some of these features. Critics pointed out that the Saskatchewan governor was a key ally of the Canadian Prime Minister, implying that this was a political decision rather than an economic decision. And, consistent with the argument that a powerful multinational business like BHP will always get its way, when the Potash door was closed on it BHP simply came back through the window. Just a few years later, BHP was a major player in the Canadian potash industry.

I believe that the public interest test for takeovers needs broadening and joining up with industrial policy. This can at least be done informally, if legislation may be difficult. The mistrust of politicians and officials is effectively a governance question. I envisage a system under which ministers will occasionally refer foreign takeovers for public interest analysis, with oversight from an independent panel.

Would the Pfizer bid for Astra Zeneca have merited a public-interest reference under such a system? Possibly. But if the takeover involved the effective and substantial relocation of the Pfizer head office to the UK, and if it brought credible guarantees about the location of future research then it would probably pass that public interest test! Publicly, politicians expressed distaste for tax-motivated takeovers – ‘we do not want the UK to become a tax haven’. On the contrary, the use of the corporate tax system to attract mobile international capital is a central plank of the U.K.’s industrial policy, just as it is for many competitor nations. Getting Pfizer to relocate would have been a significant catch.

Chris Higson, May 2015

Exhibit - UK Acquisition Capital Flows

The table shows UK Office for National Statistics data on the annual value of internal domestic acquisitions (UK UK), outward (UK For), inward (For UK), and net outward (UK For less For UK). Data are in £m for the 27 years from 1987 to Q3 2013. Historically, outward exceeds inward every year (with the marginal exception of 1995) until 2003. From 2004 on, inward significantly exceeds outward.

ONS provides some limited data on the sources of foreign acquisition capital (For UK), identifying EU- and US-source acquisitions (it is unclear whether these geographical designations refer to the immediate acquirer, or to the ultimate holding company). There is no very clear pattern in the sourcing of foreign acquisition in this data.

	UK UK	UK For	For UK	**Net Out**	*Source of foreign acquisition capital*				
					EU	*US*	*EU%*	US%	*Other%*
1987	**16,539**	12,058	2,701	**9,357**	*979*	*225*	*36%*	*8%*	55%
1988	**22,839**	17,300	5,690	**11,610**	*1158*	*872*	*20%*	*15%*	64%
1989	**27,250**	22,622	12,130	**10,492**	*3831*	*5475*	*32%*	*45%*	23%
1990	**8,329**	12,952	10,958	**1,994**	*3409*	*1785*	*31%*	*16%*	53%
1991	**10,434**	9,688	6,667	**3,021**	*1749*	*1782*	*26%*	*27%*	47%
1992	**5,941**	7,264	4,139	**3,125**	*1603*	*1591*	*39%*	*38%*	23%
1993	**7,063**	9,213	5,187	**4,026**	*941*	*2764*	*18%*	*53%*	29%
1994	**8,269**	15,164	5,213	**9,951**	*2312*	*2115*	*44%*	*41%*	15%
1995	**32,600**	11,967	12,817	**-850**	*6697*	*4793*	*52%*	*37%*	10%
1996	**30,742**	13,377	9,513	**3,864**	*1890*	*5824*	*20%*	*61%*	19%
1997	**26,829**	19,176	15,717	**3,459**	*4084*	*9823*	*26%*	*62%*	12%
1998	**29,525**	54,917	32,413	**22,504**	*5559*	*21898*	*17%*	*68%*	15%
1999	**26,163**	111,193	60,860	**50,333**	*36875*	*22597*	*61%*	*37%*	2%
2000	**106,916**	181,285	64,618	**116,667**	*41554*	*18844*	*64%*	*29%*	7%
2001	**28,994**	41,473	24,382	**17,091**	*15820*	*7061*	*65%*	*29%*	6%
2002	**25,236**	26,626	16,798	**9,828**	*11628*	*4192*	*69%*	*25%*	6%
2003	**18,679**	20,756	9,309	**11,447**	*920*	*5803*	*10%*	*62%*	28%
2004	**31,408**	18,709	29,928	**-11,219**	*13936*	*11809*	*47%*	*39%*	14%
2005	**25,134**	32,732	50,280	**-17,548**	*23907*	*11741*	*48%*	*23%*	29%
2006	**28,511**	37,412	77,750	**-40,338**	*42412*	*7606*	*55%*	*10%*	36%
2007	**26,778**	57,814	82,121	**-24,307**	*27489*	*14270*	*33%*	*17%*	49%
2008	**36,469**	29,670	52,552	**-22,882**	*17918*	*8269*	*34%*	*16%*	50%
2009	**12,195**	10,148	31,984	**-21,836**	*15277*	*11594*	*48%*	*36%*	16%
2010	**12,605**	12,414	36,643	**-24,229**	*3856*	*19124*	*11%*	*52%*	37%
2011	**8,089**	50,234	32,967	**17,267**	*6238*	*21489*	*19%*	*65%*	16%
2012	**3,413**	17,933	17,414	**519**	*3533*	*6217*	*20%*	*36%*	44%
2013 Q3	**6,428**	3,355	29,705	**-26,350**					
ONS series	*DUCM*	*CBBI*	*CBCQ*		*CBCH*	*CBCJ*			