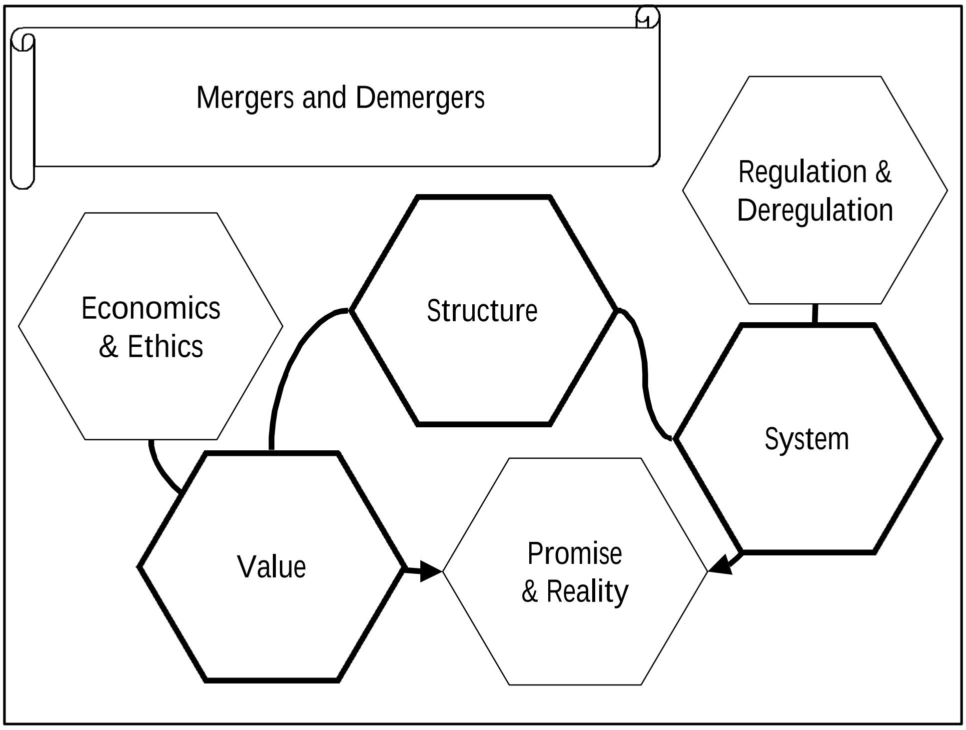


Warning Note

- This note mentions lots of actual and potential mergers and demergers, and uses them as possible illustrations of various patterns and scenarios.
- However, there are many different ways of interpreting each of these examples.
- Furthermore, our understanding of these examples is generally based on information in the public domain, which may be unreliable or misleading.

- You should therefore regard the precise classification of these examples as speculation rather than undisputed fact.

Merger as Dramatic Contest

- Mergers and demergers are dramatic business events that punctuate business-as-usual.
- Mergers are often contested (by the target company itself, by other bidders or by regulators)
- In this case, they involve competitive appeals to shareholders, regulators and other stakeholders.

- Mergers and demergers are the business equivalent of high level diplomacy and war, so we would expect the things people say and do to come under severe pressure.
- Mergers and demergers often have quite dramatic effects even beyond the companies concerned. We need to be able to understand what these effects might be and the degree to which the players take any account of the wider picture. We need to be able to challenge claims made in an intelligent way.

Merger as Promise

- Mergers have to be accepted by relevant stakeholders
  - Shareholders
  - Regulators
- Often the shareholders don't simply accept the highest bid, but are looking for the most attractive and credible promises of future value and growth.
- Meanwhile, regulators need promises of consumer value and healthy competition.

- A merger or demerger often looks very different after a couple of years. Promises of synergy, growth and competition don't always materialize; and with the benefit of hindsight, the merger or demerger can look like a big mistake.
- Indeed, some companies seem compelled to take over other companies on a regular basis, which makes it impossible ever to evaluate the success of any given acquisition - and perhaps that's the intention.

Merger as Discourse

- The principal actors in mergers and demergers typically put forward arguments that appeal to various notions of **value** and **viability**, **identity** and **continuity**.
- During merger and demerger activity, these notions are exposed for public and shareholder scrutiny, and receive more attention than at other times.

- During merger and demerger activity, corporate strategies are presented with passion and guile; and reviewed with keen sceptical interest; at other times, they are often presented and swallowed as dull paragraphs in statutory reports.
- This reminds us not to expect the truth to be simple or to be readily available, and encourages us to find alternative ways of analysing the situation to see if what people are saying really stacks up.

Merger Scenarios

- Successful competitor takes over rival
  - Sky Broadcasting takes over BSB to form BSkyB
  - RBS takes over NatWest Bank
- Merger of “equals” - two companies in same industry form larger unit to compete in a global market
  - DaimlerBenz plus Chrysler
  - GlaxoWelcome plus SmithKleinBeecham
  - Carlton plus Grenada

- Complementary companies in different industries form larger whole
  - AOL plus TimeWarner
  - National Grid plus Lattice
- Big fish - large company gobbles up small company
- Small dynamic company seizes control of larger firm
  - Wm Morrisons takes over Safeway

Demerger Scenarios

- Break-up of large public monopolies and utilities
  - British Rail
  - Telecoms, electricity and gas
- Separation of companies with different investment profiles
  - ICI minus Zeneca
  - BT minus MMO2
- Releasing small company for massive growth
  - Racal minus Vodafone

- Asset stripping - a company is worth more than the sum of its parts
  - Safeway
  - Six Continents
- Separation of companies to avoid conflicts of interest
  - Arthur Andersen minus Andersen Consulting (now Accenture)

The Ones that Got Away

Mergers that never happened

- Culture Clash
  - Volvo plus Renault
- Barred by Regulator
  - Lloyds Bank plus Abbey National

Demergers that never happened

- Successful Opposition to Forced Break-up
  - IBM
  - Microsoft
- Management Ambition / Folly Destroys Value
  - Six Continents ("Weapons of Bass Destruction")
  - GEC / Marconi

Compare and Contrast

Racal split off Vodafone

- Vodafone liberated from its parent to become a huge company
- Racal corporation only gets some of the benefits of Vodafone expansion
- Racal management may be criticized for letting go of Vodafone
- But Racal shareholders always had the option to hold on to Vodafone shares as well as Racal shares

GEC retained Marconi

- GEC corporation wanted to get all the benefits of Marconi expansion
- As Marconi grew, it took over the GEC corporation, which converted from a safe heavy engineering firm into a high risk high tech company.
- With hindsight, it seems that GEC management were representing their own interests and ego. They destroyed huge amounts of shareholder value in the process.

Merger / Demerger Combinations

Merger then demerger

- Recently merged company immediately demerges some units
  - satisfy regulation
  - avoid conflict of interest
  - rebalance corporate strategy

Demerger then merger

- Recently demerged or deregulated company is quickly acquired.
  - Very few of the deregulated water and energy utilities in the UK remained independent for long.

Reversal - demerger as the opposite of a merger

- Companies that once merged later split up again.
- Companies that once demerged later joined up again.
- *This is extremely unusual. Managers will usually avoid doing this at all costs, because it makes them look stupid.*

Sequence of Merger and Demerger

- Beer (Bass)
- Beer plus Pubs
- Beer plus Pubs plus Restaurants plus Hotels
- Pubs plus Restaurants plus Hotels (Six Continents)
- Six Continents split into two separate companies - Hotels division (InterContinental) and Pubs division (Mitchell & Butler)

- Not clear that any value has been created by all this wheeling and dealing.
- On the contrary, it seems that Bass management have wasted huge amounts of shareholder value in the process.
  - "Weapons of Bass Destruction"

Role of Regulator

- Regulators are typically concerned with fair pricing, healthy competition and market stability (not necessarily in that order).
- Regulators perform these role with varying degrees of competence and success.
- Regulators sometimes behave in surprising or inconsistent ways.
- Regulators are operating in a political environment. Large players devote resources to lobbying government as a whole as well as individual politicians.

Prices & Profits

- Prices should be fair, and as low as possible. Profits should be reasonable but not excessive.

Competition

- No player can obtain excessive market share.
- No player can take unfair advantage of its competitors or customers.
  - Prevent tactics (such as predatory pricing) to see off weaker players
  - Prevent collusion between players to fix prices.

Viability / Stability

- Maintain stability of prices and contractual obligations. Commercial failure may be allowed, but should not disrupt the market as a whole.

Culture and Identity

- British Airways was created in 1974 by a merger of British European Airways (BEA) and British Overseas Airways Corporation (BOAC).
- Decades later, two separate cultures were still visible within the organization.

- Interesting cases of demerger arise when some particular part of a company becomes so dynamic and so attached to a different market that it does not make sense to manage it under the same company umbrella.
- The way in which a part of company can develop an identity which eventually leads to separation is a subtle and interesting process.

How may mergers and demergers create value?

Mergers

- Economics of scale
- Risk Balancing

Demergers

- Investment Efficiency
  - Different Investment Profiles
  - Asset Stripping

Risk Balancing

- One of the arguments for combining different businesses within a single conglomerate is that it allows different risks to be balanced.
- For example, if one business thrives when the oil price is high, while another business thrives when the oil price is low, then yoking both together helps to mitigate the uncertainty in the oil price.
- In general, if you have lots of separate businesses within one corporation, then some of them will be more successful than others - and the performance of the corporation as a whole will average out the extremes. This means that the investment risk is lower, and the cost of capital reduced.

Counter arguments

- This balancing can and should be done by the investor, and doesn't need to be done by the corporation.
- Manager often make merger decisions to promote their own self-importance and self-interest, rather than for the benefit of shareholders.

Investment Efficiency

- Investors have different expectations of dividend yield, share price growth and risk for different business sectors. Separating businesses with **different investment profiles** allows investors to choose whether to invest in one or other or both, and allows each business to raise capital in the most efficient way.
- This argument is used to justify demerging stable high-yield businesses, such as utilities, from high risk growth operations, such as high tech.

- A large company is often worth less than the sum of the parts. In the 1960s and early 1970s, this led to a pattern of **asset stripping**, where companies with undervalued assets would be taken over and the assets sold.

Systems Theory

Basic question

- **Which system?** What are the system boundaries, what is contained within those boundaries and what is the relevant environment for that system?
- If you look at different systems around a merger you will see different effects and be able to draw different conclusions.

Possible choices of system

- The system consisting of the companies that are merging in an environment consisting of their main competitors. This system is concerned with the merger as a move in a power game of competition for survival.
- The system of companies within that industry sectors in an environment of the market for products and services. Regulation of this system is concerned with whether competition acts to improve the range, quality and price of these products and services and therefore whether a merger is in any sense beneficial to the wider world.

Gaining critical distance

- Because the information you are going to find by researching mergers will be heavily slanted towards the way management (or perhaps some other interest group such as the unions) is presenting the issues, then you are going to need critical distance if you are to interpret the data.
- One way of gaining critical distance is to compare similar situations for their common properties and their differences. This is a typical way for sociologists to proceed.

- Alternatively, we may compare words with deeds. Let's use ethics as an example of how to do this:

Ethics

- An ethical company will want to put forward genuine statements and to honour its commitments wherever possible.
- Ethics is about principles - in this case whether a company keeps its word and means what it says.

Merger or demerger exposes ethical claims

- Companies often make ethical declarations:
  - Our staff are our greatest asset
  - The customer is king
  - We protect the environment
- They also make commitments to other stakeholders such as shareholders, regulators, suppliers and strategic partners.
- These statements and commitments might be genuine or they might be mere window dressing. All of them can be compared to what actually happens during the merger process.

- In a merger situation we get signs of whether a company is ethical or not:
  - Are staff consulted in a meaningful way about a possible merger or demerger?
  - Are customer interests factored into the negotiations or are profit and survival the only real issues?
  - Is the environmental record of the target company an issue?
- Mergers involve much change, and substantive change is only possible on the basis of trust and communication.
- If management is perceived not to be keeping its word the implementation of the merger will fail in important ways.

Testing a sociological hypothesis

Hypothesis

- “Mergers are a game that managers play to further their own narrow interests.”
- “Although management's formal role is to act as agents for shareholders and to look after their interests, the data is consistent with them always putting their own interests ahead of the shareholders interests and sometimes they even sell their shareholders down the river.”

Ways of Testing

- We could observe the merger process to see who was involved in the process and what power they appeared to have to alter its course.
  - How often do shareholders actually manage to reject a course of action put forward by management?
  - How often do staff get to veto a proposed merger? Does this vary around the world?
- We could look at the outcomes of a number of mergers in terms of the degree of benefit (or disbenefit) that various stakeholders had achieved in statistical terms. If managers are the only group that consistently win that would tend to confirm our hypothesis.
- We could form other hypotheses to test against each case and against the bigger picture.

General Weaknesses

- Many of you blithely quoted economies of scale (bigger is better) as a reason for merger and diseconomies of scale (small is beautiful) as a reason for demerger. In an essay of this nature you need at least to say how both these mechanisms can be valid and how you might understand which was more important in a given situation.

- Very few of you when quoting regulations and laws thought it necessary to talk about where those laws might apply. Clearly regulation in the USA is different from that in the EU and this ought to be a source of interesting comment, not a piece of vagueness.

The four pillars

- Ethics
- Economics
- Sociology
- Systems Theory

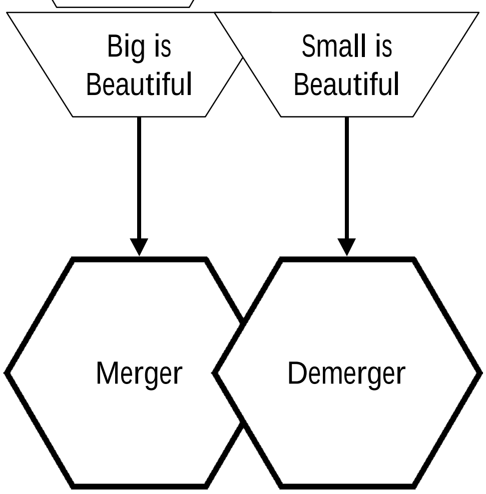
- An implication of having four pillars, like having four legs to a table, is that if one is missing or even a bit short, the table is not very useful.
- Clearly we had not covered all the pillars in class at the time you were completing the assignment.
- We did not expect sophisticated arguments in each area but we did expect that you would work out why each was important.

Closing the loop

- You are expected to be able to generate alternative descriptions of an event like a merger using each of the four pillars.
- Not until you have different perspectives can you compare them and look at the differences between say the economic and the ethical arguments.

- All the essays assumed that economics was the primary domain. Most people put forward arguments along the lines of "bigger is better because". But you also commented that a majority of mergers fail to meet their (economic) objectives.
- So the economic arguments can be primary in this case because their version of cause and effect does not appear to work. Management present their case in economic terms because it is accepted that these arguments outweigh arguments from other domains. By doing this course you are in a position to point out that these beliefs are not safe.

Balancing Conflicting Mechanisms



- "Big is Beautiful" might help to explain mergers
- "Small is Beautiful" might help to explain demergers.
- It is normal in the social sciences to find multiple conflicting mechanisms, pulling in opposite directions.
- You need to show how both these conflicting forces may be in play at the same time.
- You then need to identify which force takes precedence in a given situation.

- A good analytical report will describe the balance of relevant forces.
  - *on the one hand … on the other hand …*
- It will then draw well-argued conclusions.