Takeover activity in the 1980s

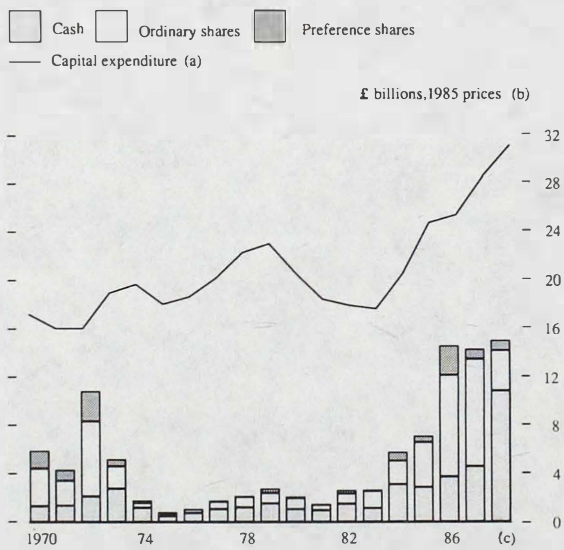
The last three years have witnessed a surge of takeover activity in the United Kingdom which has been unprecedented in its duration, in the volumes of expenditure involved and in the size of some of the transactions. Moreover, many companies have undertaken cross-border acquisitions, particularly in the United States. Associated with these developments have been substantial changes in many companies' organisational and financial structure.

This article[1] describes takeover activity by UK companies in recent years, placing the developments in their historical, international and regulatory context. Some possible explanations for the boom are considered, and the importance of financial factors—such as companies' liquidity and the willingness of the equity market to absorb new issues of ordinary shares—is underlined.

Introduction

Takeover expenditure in the United Kingdom last peaked in 1972, when industrial and commercial companies (ICCs) made 1,210 acquisitions and spent just over £2.5 billion (at 1972 prices). This latter figure was, however, boosted by a few very large transactions; a similar number of companies were taken over in 1973, although the level of expenditure was only about one half as large. In the following ten years, takeover activity was much more subdued, but in 1984 there were signs of a revival, and in each of the four years since then nominal takeover expenditure rose. The growth in acquisitions expenditure in the last five years has been accompanied by a large rise in ICCs' capital expenditure (see Chart 1) which has almost doubled in real terms since 1983. Thus, the increased takeover activity appears to be partly related to a widespread desire of companies to expand.

Chart 1
Acquisitions and capital expenditure



(a) 1988 estimated.
(b) GDP expenditure deflator.
(c) Figures for 1988 acquisition expenditure relate to the first three quarters only.

Official acquisition statistics are not available on an internationally comparable basis. Nevertheless, it is clear that takeover activity has been strong since 1985 in the major OECD economies, particularly in the United States, but also in Germany, France and Canada. The wave of activity in the United Kingdom is, however, quite distinct in character, with hostile bids being more commonly observed than in other EC countries, and with considerably more emphasis on equity finance than is the case in the United States.

UK takeover activity

The Department of Trade and Industry provides detailed coverage of domestic acquisitions and mergers by ICCs. Takeover activity by financial companies has not been recorded in official statistics since 1979, although some indication of the significance of financial acquisitions can be gained from data collected prior to that date. In the period 1973–78, acquisitions by financial companies accounted for 10% of all recorded acquisitions in the United Kingdom (by number) and for 23% of acquisitions expenditure. In the last few years it is likely that, as with the non-financial sector, takeover activity by financial companies has risen sharply, boosted for example by the diversification of insurance companies into services such as estate agency, and the formation of financial conglomerates in the period prior to 'Big Bang'.

Some details of the pattern of recent domestic takeovers by ICCs are provided in Table A. From the table, several features emerge:

- *The relative importance of a small number of large transactions.*
  Since the beginning of 1984, there have been 326 takeovers involving expenditure of over

(1) Written by R S Benzie in the Bank's Economics Division.

Table A
Analysis of takeover activity by industrial and commercial companies in the United Kingdom, 1984–88
£ billions, *numbers of acquisitions in italics*

	1984		1985		1986		1987		1988(a)		Total	
Total acquisitions	5.5	*568*	7.1	*474*	14.9	*696*	15.4	*1,125*	17.1	*920*	**60.0**	*3,783*
of which:												
Independent(b)	4.4	*398*	6.3	*340*	12.1	*537*	11.3	*905*	12.7	*701*	**46.8**	*2,881*
Subsidiary	1.1	*170*	0.8	*134*	2.8	*159*	4.1	*220*	4.4	*219*	**13.2**	*902*
Analysis by size of acquiree:												
Over £25 million	4.0	*32*	5.7	*38*	12.7	*64*	12.0	*107*	14.4	*85*	**48.9**	*326*
Under £25 million	1.5	*536*	1.4	*436*	2.2	*632*	3.3	*1,018*	2.7	*835*	**11.1**	*3,457*
Analysis by industrial category of acquiror:												
Food, drink and tobacco	0.8	*44*	1.4	*39*	4.5	*57*	0.8	*48*	3.1	*38*	**10.6**	*226*
Chemicals and man-made fibres	—	*9*	0.2	*17*	0.1	*13*	0.1	*16*	0.1	*14*	**0.5**	*69*
Metals and engineering	1.0	*144*	0.5	*113*	1.2	*177*	2.6	*295*	2.2	*204*	**7.5**	*933*
Textiles	0.1	*25*	0.3	*22*	1.0	*32*	0.3	*62*	0.3	*41*	**2.0**	*182*
Other manufacturing(c)	1.7	*61*	0.9	*60*	3.9	*124*	3.1	*188*	2.2	*132*	**11.8**	*565*
Total manufacturing	3.6	*283*	3.3	*251*	10.7	*403*	6.8	*609*	7.9	*429*	**32.4**	*1,975*
Wholesaling, retailing, hotels and catering	0.9	*93*	2.1	*76*	1.8	*108*	2.6	*177*	2.3	*171*	**9.6**	*625*
Mixed activity (mainly non-manufacturing)	0.2	*9*	0.7	*21*	0.8	*19*	2.4	*41*	1.4	*22*	**5.5**	*112*
Other(d)	0.8	*183*	1.0	*126*	1.6	*166*	3.6	*298*	5.5	*297*	**12.5**	*1,070*

— Indicates less than £50 million.

Source: *Business Monitor MQ7*. Department of Trade and Industry.

(a) Excluding fourth quarter.
(b) Including mergers.
(c) Including mixed activities (manufacturing).
(d) Agriculture, energy, construction, transport and communication, real estate and services.

£25 million, compared with 3,457 smaller ones. The larger takeovers, however, accounted for 81½% of total expenditure. This feature of the boom was especially noticeable in 1986, when two acquisitions—that of the Imperial Group by Hanson Trust, and that of Distillers by Guinness—accounted for one third of acquisitions expenditure in that year. The ten largest successful bids in the last four years are shown in Table B.

Table B
Ten largest UK acquisitions, 1985–88

Acquiring company	Acquired company	Value of transaction (£ millions)	Year
Nestlé(a)	Rowntree	2,666	1988
Hanson Trust	Imperial Group	2,564	1986
Guinness	Distillers	2,531	1986
British Petroleum	Britoil	2,323	1988
Vantona Viyella	Coats Patons	738	1986
Argyll Group plc	Safeway Food stores Ltd	681	1987
BAT	Hambro Assurance	662	1985
British and Commonwealth Holdings plc	Exco International	641	1987
Burton	Debenhams	579	1985
Associated Dairies	MFI	571	1985

(a) Nestlé's takeover of Rowntree is recorded both as a transaction by a UK ICC and as an indirect, cross-border acquisition.

- *The sectoral distribution of takeover activity.* With the exception of 1986, non-financial takeover activity has been fairly evenly distributed between the manufacturing and non-manufacturing sectors. Within the manufacturing sector, activity appears to have been relatively high in the food, drink and tobacco industries and low in the chemicals and man-made fibres industries. The effect of the takeover wave on aggregate concentration in the manufacturing sector cannot, as yet, be discerned. In 1986, the latest year for which figures are available, the share of the largest 100 firms in manufacturing net output was 38%, a slightly lower figure than in the 1970s, when the corresponding share was around 40%.

- *Sales of subsidiaries.* These have constituted 22% of ICCs' takeover transactions in the last five years, a significantly higher proportion than in the boom of the early 1970s, when about 12% of acquisitions took this form. This is one indicator that restructuring, rather than the pursuit of size *per se*, is a significant factor in the current wave. In many instances these sales of subsidiaries are disposals of unwanted parts of earlier acquisitions.

The last couple of years have also witnessed a substantial increase in the number of management buyouts, and these are partly reflected in the statistics in Table A. Management buyouts involve the transfer of ownership of a company from the existing shareholder(s) (in many instances a parent company) to the incumbent management. The managers may acquire the equity on their own personal account, or via a company set up for the purpose; it is only in the latter situation that the transaction is classified as a takeover.

The takeover process

A majority of acquisitions in the United Kingdom involve the change of ownership of small, private companies. Such transactions are, however, rarely of concern to either the official bodies responsible for competition policy or the securities markets regulators. These bodies have tended to be concerned with the smaller number of takeovers of publicly quoted companies, which are typically much larger and have on occasion been thought to involve issues affecting the public interest.

Since 1973, all proposed takeovers above a certain size,[1] and all those involving companies which have a combined market share of more than one quarter, have been considered by the Office of Fair Trading for possible referral to the Monopolies and Mergers Commission. In practice, at 2%–3%, the proportion of eligible bids which have actually been referred has been small, and about one third of bids so referred have subsequently proceeded, having been found acceptable to the Commission. In July 1984, it was announced that references would be made primarily on competition grounds. The Department of Trade and Industry document, *Mergers policy*, published in March 1988, confirmed that this emphasis on competition will remain, while at the same time indicating a desire to keep intervention to a minimum.[2]

The other main institutional element in the takeover process in the United Kingdom is the Takeover Panel, which enforces the City Code on Takeovers and Mergers. The Panel's role is to act as the referee of the fair conduct of takeover bids and in particular to ensure that all the shareholders involved in a bid are treated fairly. It does not consider the broad questions of competition policy and the public interest. The code itself does not have the force of law, although it does operate within a legal framework which gives indirect backing to its decisions.

As a referee, the Panel is careful not to favour either the offerer or offeree, but by applying the principle of fairness to shareholders it does constrain what each can do. For example, one fundamental principle is that there should be equal treatment of all shareholders in a particular class. Accordingly, a bidder who acquires 30% or more of the voting rights of a company is required to make a cash offer to all other shareholders at the highest price paid by him in the previous year. A second principle is that the management of a target company should not deny shareholders the opportunity of considering a bid for the company. This prevents a management defending a company against a bid by taking 'poison pills' without the consent of shareholders at a general meeting.

The regulatory regime in the United Kingdom is designed neither to inhibit nor encourage takeovers, but to encourage competition and ensure fair treatment of shareholders. Most public companies thus remain subject to the possibility of takeover. Size does not provide complete immunity from takeover, except perhaps for the very largest companies; Rowntree, acquired in the third quarter of 1988, was the ninety-first largest UK company by turnover, according to *The Times 1000*. Hostile bids usually involve a substantial rise in the target company's share price, however; several contested bids in recent years have failed at premiums approaching 50% of the pre-bid share price, and the average premium for successful such bids may not be very different from this level. In fact, the large majority of acquisitions are agreed by the controllers of the target company. In an examination of 350 completed bids for UK public companies between January 1986 and June 1988, only nineteen instances could be identified in which the bid was opposed. Eleven of the remaining transactions were agreed in the context of a rival, hostile bidder, and at least ten others were initially opposed by the management, although agreement was reached later. The DTI's figures on inward acquisitions indicate that here, too, hostile bids are comparatively rare. During the period from the beginning of 1986 to the third quarter of 1988, the DTI identified 157 inward acquisitions into the United Kingdom, of which only five were contested.

The motives for acquisition

There are several explanations of takeovers, although in many cases more than one may be relevant:

- *Horizontal takeovers.*
  According to the Office of Fair Trading, about two thirds of proposed acquisitions which they have considered in the past three years have involved a company taking a larger share of output in its existing markets. Furthermore, it is likely that an even higher proportion of takeovers which are not considered by the Office are horizontal in character. There are several possible motivations for such a transaction: increased market power (although the ability to exploit this power is likely to be viewed with particular concern by the competition authorities), the transfer of relevant production technology and marketing expertise, and the attainment of economies of scale by rationalising production or by operating fewer, more efficient plants.

- *Hostile takeovers.*
  A small but significant proportion of bids are actively opposed by the incumbent management of the target company. Takeovers of this type involve the payment by the acquiring firm of a substantial premium over the pre-bid share price of the target. The paying of this premium is borne by the shareholders of the acquiring company, and this premium will only be borne willingly if it is perceived that the profitability of the joint assets can be substantially improved. The establishment of the hostile bid as a feature of the market for corporate control in the United Kingdom suggests that in certain instances such an improvement is thought to be feasible. It has been suggested that the owners of equity in a company subject to a hostile

(1) At present, those in which the gross value of the worldwide assets taken over, or in which a substantial interest is being acquired, exceeds £30 million.

(2) A more recent statement of present policy, including a discussion of the considerations underlying the decisions to refer or not refer particular bids in the last year, was made in an address presented to the Stock Exchange Conference for Industry by the Secretary of State for Trade and Industry on 27 October, 1988.

bid have an incentive not to sell their holdings,[1] although it is difficult to gauge the extent to which this kind of behaviour is a serious obstacle to the success of such bids in practice.

- *The tax regime.*
  One important financial consequence of a takeover is that, to the extent that it is cash-financed, it is likely to result in a transfer of cash out of the company sector. From the flow of funds point of view, therefore, the effect of a cash-financed takeover resembles that of a dividend payment, raising the question of whether takeovers are a tax-efficient method of transferring cash out of the company sector. A similar question has been considered elsewhere, namely, the relative tax efficiency of a company buying back its own shares in comparison with the payment of dividends.[2] It appears that, although in some instances a cash-financed takeover may be tax efficient, these cases are probably exceptional.

One gain which may accrue to the combined, larger company stems from the interaction of capital structure preferences and the tax system. It is likely that after the acquisition the debt-equity ratio of the joint company will be raised; larger companies, with less variable income, tend to regard higher ratios with less concern. Since debt-servicing costs are deducted from corporate income when assessing tax liability, this increased debt-equity ratio will produce a tax saving for the companies.

Another aspect concerns the tax treatment of losses. In the United States, until very recently, this factor has provided an incentive to acquire. A company which had made a large loss, and which did not expect to pay corporation tax for a long time, could gain immediate benefit by combining with a profitable tax-paying firm. In the United Kingdom, tax law restricts the realisation of tax benefits of this sort. A careful distinction is drawn between the tax position of different companies within a group, and the losses of one member, incurred prior to the date at which it was acquired, cannot be offset against the profits of another member company. Brought-forward tax losses can only be offset against future profits of the same company and even then only if it continues to operate the same type of business.

Characteristics of acquiring and acquired firms

The different characteristics of acquiring and acquired firms have been the subject of a number of studies, utilising company accounts data.[3] The main feature to emerge from these studies is that acquiring firms, on average, are considerably larger than their targets. Several other variables have been examined, such as the rate of return, liquidity and income gearing, but the conclusions here are more uncertain.

This approach has been updated in some work at the Bank, in order to highlight any distinctive features of the recent boom. A total sample of 1,552 companies, whose reports for the financial year 1985/86 were available on Datastream, were examined. Within this total, a subsample of 273 companies (17.6%) reported positive expenditure on acquisitions. A second subsample was extracted, consisting of 135 companies which were acquired during the period 1985–87. The main results to emerge from comparing the total group and the two subsamples are described in Table C. The work confirmed the importance of size as a distinguishing characteristic; nearly 20% of acquiring firms had gross fixed assets of over £100 million, compared with 13% of the total sample and less than 6% of the sample of acquired companies. In addition to this, several differences emerged between the financial position of acquiring firms and that of the average of the whole sample—acquirers are less likely to have made losses in the recent past, and tend to have larger holdings of liquid assets. It was also found that acquired companies tended to be less dependent on debt finance, suggesting that the acquisition may have resulted in a rise in the debt-equity ratio of the joint company and an associated reduction in corporation tax payments.

Table C
Differences between acquiring and acquired companies

Characteristic	Accounting measure used	Comments
Size	Gross fixed assets	Few acquired firms were large, in comparison with the total sample. A relatively large number of acquiring firms were large, in comparison with the total sample.
Profitability	Trading profits as a proportion of gross fixed assets	Relatively few acquiring companies made losses. Acquiring companies appear to be slightly more profitable than on average. The profitability of acquired companies was similar to that of companies in the total sample.
Income gearing	Total interest charges as a proportion of post-tax profit	Acquired companies tended to have lower than average income gearing. A relatively small proportion of both acquired and acquiring companies had high income gearing.
Liquidity	Total cash and equivalent as a proportion of gross fixed assets	Little difference between acquired firms and the total sample. Acquiring companies less likely than on average to be illiquid.

The financing of acquisitions

Although takeovers may occur for a combination of reasons, it is not immediately clear why any of these

(1) Grossman, S and Hart, O. 'Takeover bids, the free rider problem, and the theory of the corporation' *Bell Journal of Economics*, vol 11, no 1, Spring 1980, pages 42–64. A discussion of the problem in the UK context, and of the role of the takeover code in limiting the free rider problem, is to be found in Yarrow, G 'Shareholder protection, compulsory acquisition and the efficiency of the takeover process' *Journal of Industrial Economics*, vol 34, no 1, September 1985, pages 3–16.
(2) See the August 1988 *Bulletin*, page 389.
(3) A review of some of the studies on UK data is provided in Levine, P, and Aaronovitch, S. 'The financial characteristics of firms and theories of merger activity', *Journal of Industrial Economics*, vol 30, no 2, December 1981.

motives would have been strengthened in the last few years. There have, for example, been no major changes in the corporate tax system recently which could be interpreted as favouring larger companies. Indeed, the reduction of the corporation tax rate to 35% has probably made debt finance significantly less attractive to companies than in the early 1980s, when takeover activity was quite modest.

It is likely that part of the explanation for the recent boom lies in the changed financial position of companies; a crucial element of any successful bid is the availability of finance. Table D provides a breakdown of expenditure on acquisitions, showing the proportions which have been met by the payment of

Table D
Categories of expenditure on domestic acquisitions by industrial and commercial companies[(a)]
£ billions, *percentages in italics*

	1984		1985		1986		1987		1988(b)		Total	
Cash	2.9	*53.8*	2.9	*40.3*	3.8	*25.6*	4.9	*32.2*	12.3	*71.9*	**26.8**	*44.8*
Issues of ordinary shares	1.8	*33.6*	3.7	*52.3*	8.6	*57.9*	9.6	*62.3*	3.8	*22.2*	**27.5**	*46.0*
Issues of fixed-interest securities	0.7	*12.6*	0.5	*7.4*	2.5	*16.5*	0.8	*5.5*	1.0	*5.9*	**5.5**	*9.2*

Source: *Business Monitor MQ7.*

(a) The figures in the table relate to payments made to the shareholders of acquired companies. If a company raises funds by a capital issue, and then subsequently pays the shareholders of an acquiree cash, this transaction would only affect the first row of the table.
(b) Excluding fourth quarter.

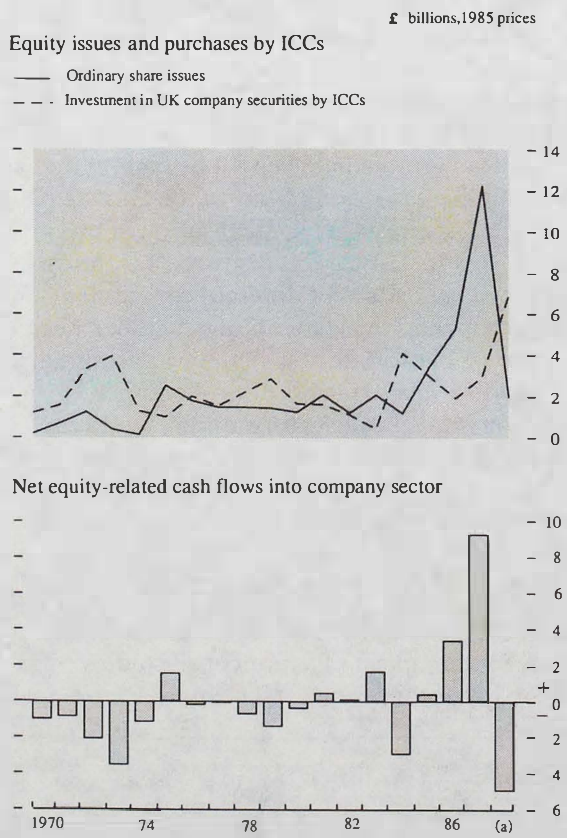
cash, the issue of ordinary shares and the issue of fixed interest securities. In the three-year period prior to the sharp fall in equity prices in the autumn of 1987, over half of takeover expenditure took the form of an exchange of equity between the acquiring company and the shareholders of the acquiree. Since that point, the proportion borne by cash payment has risen noticeably, and in the twelve months to September 1988 a total of £14 billion of cash was paid by ICCs as a result of acquisitions made during the period. The proportion of expenditure met by the issue of fixed-interest securities has, throughout the boom, been much lower than that met by the other two methods of financing. These issues, about £5.5 billion in total since 1984, have, however, constituted 85% of all new issues of fixed-interest securities by ICCs during this period.

It seems that the choice of the form of payment in a takeover transaction is unrelated to the size of the acquisition. Thus, in an analysis of the accounts of acquiring companies reporting on Datastream in the financial years 1985/86 and 1986/87, little discernible link was found between the size of the transaction involved and the form of payment employed. The only qualification to this finding was the fact that the two largest acquisitions of 1986 were almost entirely paid for by issues of securities, rather than cash.

The importance of the equity market in facilitating takeovers is evident from the figures in Table D. Acquisitions in which payment is made through the issue of ordinary shares involve an increase in the acquirer's outstanding equity, and shareholders of the acquiree may be unwilling to hold this equity in their own portfolios. From the point of view of the acquirer, therefore, it is desirable that other willing holders of the newly issued equity be found, so that the impact of the transaction on its share price is minimized. It is the case, moreover, that a clear link exists between cash expenditure on acquisitions and the issue of ordinary shares. This fact was underlined in a Bank study of ninety-five domestic capital issues which occurred between July 1986 and August 1987. The indications were that around half of the cash raised in capital issues is disbursed within six months in acquisitions expenditure. Of the eleven capital issues identified which involved sums of over £250 million, seven of the issuers were subsequently engaged in takeover activity, and almost 80% of the cash raised in these issues was spent on acquisitions.

The historical pattern of equity-related cash flows affecting ICCs is shown in Chart 2. Throughout the 1970s, but particularly in the first half of the decade, more cash flowed out from the sector as a consequence of takeover activity than flowed into it via new equity issues. In 1972 and 1973, £1.2 billion worth of ICCs' equity, about 3% of the value of their total equity at the end of 1973, was transferred into corporate control as a result of cash expenditure on acquisitions. During the two years, an additional £0.7 billion of equity was exchanged for fixed-interest securities. The situation in

Chart 2
Equity creation by ICCs



(a) 1988 figures exclude the fourth quarter.

Table E
Takeover activity by ICCs and selected financial indicators[a]

	Takeover expenditure	*of which: cash*	Financial balance	Valuation ratio(b)	Net liquidity(c)	Gross liquidity(d)	Capital gearing(e)	Net income gearing(f)	Gross income gearing(g)	Real rate of return(h)
	£ billions, 1985 prices				Per cent					
	(1)	*(2)*	*(3)*	*(4)*	*(5)*	*(6)*	*(7)*	*(8)*	*(9)*	*(10)*
Year										
1969	6.0	*1.7*	2.5	1.21	− 5.4	9.8	15.2	12.2	16.5	10.3
1970	5.9	*1.3*	−0.6	1.07	− 7.2	8.6	16.7	12.5	16.2	9.0
1971	4.3	*1.3*	5.2	1.23	5.9	− 9.5	17.6	11.1	14.0	9.2
1972	10.9	*2.1*	7.1	1.24	− 6.5	11.8	17.0	13.2	17.5	9.4
1973	5.2	*2.7*	1.9	0.79	− 9.1	13.1	15.7	17.8	25.3	9.2
1974	1.7	*1.2*	−7.7	0.59	−11.4	9.9	14.7	27.1	34.2	5.3
1975	0.8	*0.5*	0.9	0.70	− 6.6	9.9	10.4	18.5	26.3	4.2
1976	1.0	*0.7*	−0.9	0.57	− 6.9	9.8	9.9	19.4	27.3	4.3
1977	1.7	*1.1*	2.0	0.72	− 5.6	9.8	8.5	12.6	16.8	6.8
1978	2.1	*1.2*	2.8	0.62	− 4.9	9.7	7.1	16.3	22.7	7.2
1979	2.7	*1.5*	−1.5	0.58	− 5.5	8.3	7.2	18.2	25.2	5.7
1980	2.0	*1.0*	0.5	0.61	− 5.7	8.4	7.2	23.1	31.2	3.8
1981	1.4	*1.0*	2.0	0.53	− 6.3	9.8	7.4	24.3	33.8	2.8
1982	2.6	*1.5*	4.0	0.66	− 7.5	10.8	9.1	16.8	23.1	4.1
1983	2.6	*1.1*	6.8	0.73	− 6.0	12.6	7.7	12.2	20.2	4.9
1984	5.8	*3.1*	7.3	0.77	− 7.5	12.7	10.5	11.4	18.6	5.5
1985	7.1	*2.9*	6.2	0.81	− 7.8	12.3	10.2	11.2	19.6	7.2
1986	14.5	*3.7*	5.3	0.84	− 7.9	13.7	11.0	11.6	20.3	8.9
1987	14.3	*4.6*	8.4	0.72	− 6.5	14.3	9.1	8.2	15.5	10.2

(a) Columns (1)–(3) are annual totals, columns (4)–(7) relate to the end-year position of companies, and columns (8)–(9) are constructed from fourth quarter flow data.

(b) The net financial worth of ICCs as a proportion of the replacement cost of their capital stock.

(c) ICCs' net liquid assets as a percentage of the replacement cost of their capital stock.

(d) ICCs' gross liquid assets as a percentage of the replacement cost of their capital stock.

(e) Total ICCs' debt as a percentage of the replacement cost of their capital stock.

(f) Net interest payments—gross interest payments less non-trading income—as a percentage of non-interest income, net of stock appreciation, tax payments and capital consumption.

(g) Gross interest payments as a percentage of income, net of stock appreciation, tax payments and capital consumption.

(h) Non North Sea companies' pre-tax real rate of return, annual rate.

the 1980s has been less clear-cut, as the lower panel of Chart 2 demonstrates. Overall, in the last five or six years, there has been some net equity-related inflow of cash into the sector, largely as a result of the unprecedented volumes of ordinary share issues during 1987. In 1988, however, there occurred an equally unprecedented takeover-related cash outflow; in the year to September 1988 this outflow resulted in a 3% reduction in the value of ICCs' equity held by agents outside the sector—a significant proportion, although small in comparison with the change associated with the 27% fall in equity prices during October 1987.

The view that the wave of takeover activity in the late 1980s has been prompted to a considerable extent by financial developments is lent support by the data in Table E. In almost every respect, ICCs have, since 1984, been in a financial position of exceptional strength. They appear to have been in substantial financial surplus throughout the period (although the large unidentified outflow which has emerged in ICCs' financial accounts in the last two years casts some doubt on the size of this surplus), their holdings of liquid assets have reached unprecedented levels and, until the recent rise in short-term interest rates, income gearing figures suggested substantial scope for increased use of debt finance. Furthermore, the rate of return has been steadily rising, and by the end of 1987 was at a higher level than at any time since the late 1960s. This high rate of return earned on physical assets eases the burden of servicing any increased debt resulting from acquisition expenditure.

International aspects of the boom

Acquisition is one of the chief means of engaging in direct investment abroad.[1] The flows of inward and outward direct investment are shown in Chart 3; from the chart it can be seen that about half of UK companies' direct investment abroad in the last ten years took the form of the acquisition of overseas' share and loan capital (of which a considerable

Table F
Recent cross-border acquisitions and disposals affecting UK companies

£ billions, *numbers of transactions in italics*

	1986		1987		1988(a)	
Transactions overseas by UK companies						
Acquisitions	**8.9**	*317*	**11.5**	*419*	**8.4**	*406*
of which:						
Direct transactions	5.4	*216*	6.0	*283*	3.6	*295*
Indirect transactions(b)						
(i) funded by UK company	1.6	*55*	3.4	*61*	2.3	*73*
(ii) funded locally overseas	1.9	*64*	2.1	*94*	2.5	*59*
Disposals	2.2	*117*	3.9	*116*	2.1	*85*
of which:						
Direct transactions	1.0	*95*	1.2	*90*	1.5	*58*
Indirect transactions(b)						
(i) funds remitted to UK parent	—	*4*	0.2	*6*	0.1	*4*
(ii) funds retained overseas	1.2	*20*	2.5	*22*	0.6	*25*
Transactions in the UK by overseas companies						
Acquisitions	**2.9**	*52*	**2.3**	*57*	**5.0**	*48*
of which:						
Direct transactions	1.1	*38*	1.5	*47*	1.8	*37*
Indirect transactions	1.8	*14*	0.8	*10*	3.2	*11*
Disposals	0.5	*15*	1.2	*16*	0.5	*17*
of which:						
Direct transactions	0.5	*14*	1.1	*14*	0.5	*14*
Indirect transactions	—	*1*	0.1	*2*	—	*3*

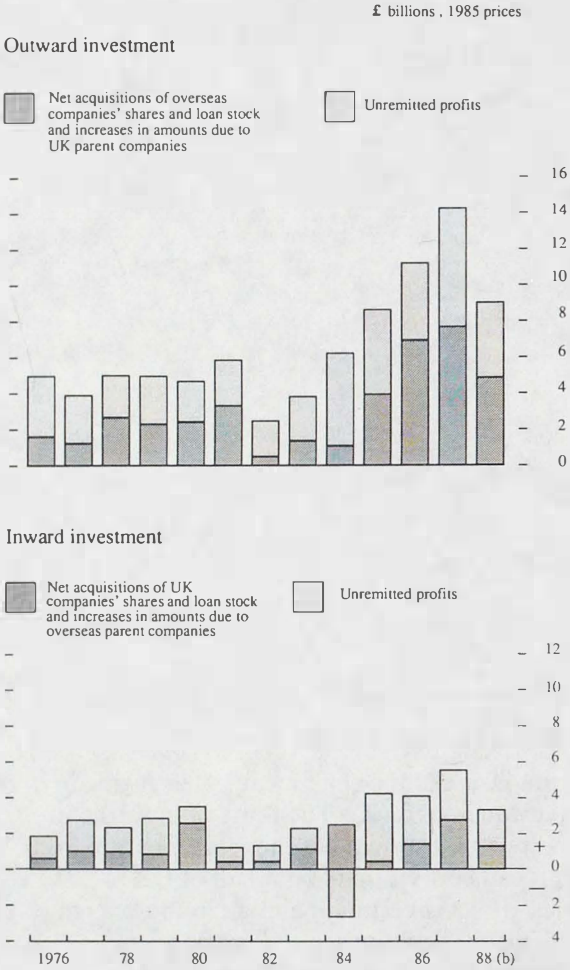
Source: *British Business*.

(a) Excluding fourth quarter.

(b) Some transactions are funded by more than one method.

(1) Not all overseas acquisitions expenditure is categorized as direct investment, however. Direct acquisitions are recorded as direct investment, but indirect acquisitions are only so recorded to the extent that the funds are provided by the parent company. For further discussion of this point, see *British Business*, 28 October 1988, pages 26–7.

Chart 3
Cross-border direct investment (a)



Source: Business Monitor MA 4.

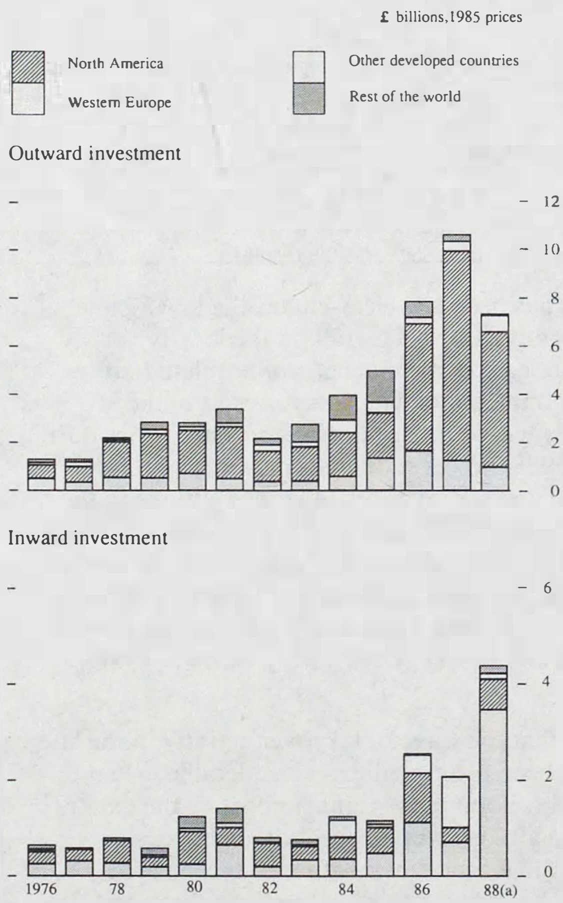
(a) Figures prior to 1984 exclude oil companies.
(b) Figures for 1988 exclude fourth quarter.

proportion was takeover related). The remainder consisted of unremitted profits and changes in a subsidiary's or branch's indebtedness to the UK parent.

Some upward trend in outward direct investment is discernible in Chart 3, although the change in data coverage after 1983 makes a precise comparison impossible. Inward direct investment was smaller in magnitude, and does not appear to have risen as strongly, especially recently. The same point emerges in Table F, in which it is shown that overseas acquisitions by UK companies have outnumbered inward acquisitions by more than seven to one since 1986, and have been almost three times as large in terms of total expenditure involved. The table also highlights the distinction between the two main forms of cross-border takeover—direct transactions, in which a company in one country acquires a controlling interest in a company incorporated in another country; and indirect transactions, in which a company uses an existing, or sets up a new, overseas subsidiary in order to acquire a controlling interest in a company incorporated in another country. The majority of both inward and outward takeovers are of the direct type, as the table shows.

Outward acquisitions by UK companies in the last three years have been concentrated in North America, where almost 80% of expenditure has been made (see Chart 4). However, transactions there have typically been much larger than elsewhere, and the number of acquisitions made in other developed countries has been almost as large. The geographical origin of inward acquisitions in the United Kingdom has shown a markedly different pattern, with over half of the expenditure incurred by companies from developed countries outside the EC or North America, such as Switzerland and Australia.

Chart 4
Geographical composition of cross-border net acquisitions



(a) Figures for 1988 exclude the fourth quarter.

The contribution of US companies has been quite modest; since the beginning of 1986 they have made forty-seven acquisitions and most of these have been relatively small. Indeed, during this period the value of disposals by US companies in the United Kingdom has exceeded the value of their acquisitions.

The growth and pattern of UK companies' outward acquisitions are remarkable and require explanation. It is likely that the growth of overseas activity is partly associated with the same factors that have contributed to a domestic boom—in particular, the strong financial position of the corporate sector. Nevertheless, the focus of activity in the United States, where, according to the Department of Commerce, the share of inward acquisitions by UK companies has recently been higher than that of any other country, appears to be due to a special set of factors.

The recent expansion of UK companies in the United States represents the continuation of a well-established trend (Chart 4). For many British companies (for example, Hanson Trust and BET) the decision to expand into that country is a long-standing strategic one. The choice of the United States appears to be obvious for many well-established domestic companies. A number of reasons have been adduced for this, in particular:

- the openness of the US capital markets and the ease with which large (and often hostile) bids can be made in them;
- the large size of the US product markets;
- the absence of a language barrier; and
- the depreciation of the dollar in the last few years.

The majority of acquisitions by UK companies outside the United States have been made in Western Europe. The average transaction in this region has, however, been only about one quarter as large, at just under £10 million. There has been some growth in activity in EC countries, and it is likely that UK companies' takeover expenditure in 1988 in these countries will exceed the record 1987 figure of £1.2 billion. This trend may well continue, in view of the prospects of the 1992 reforms, although the likelihood of a substantial shift of emphasis in UK companies' overseas takeover activity appears small; the establishment of common product markets will not be an instantaneous process, and formidable obstacles, in the form of the language differences and substantial variations in capital market regulations, remain.

Conclusion

It is clear that the exceptional level of takeover activity by UK companies since 1984 cannot be attributed to any one particular cause. Public merger policy, an increased desire of many managements to expand the scope of their operations and liberalisation of international capital markets have all exerted a significant influence. In the United Kingdom, the strong financial position of the corporate sector has perhaps contributed more than any other single factor. In terms of profitability, liquidity, income and capital gearing, the sector has been in a more favourable situation than at any time since the late 1960s, enabling many individual companies to accommodate easily the increased financial burdens which most takeovers initially involve. Although a number of well-publicised hostile takeovers have occurred, with the acquirer paying a substantial premium on the pre-bid share price, the large majority of acquisitions take place on terms agreed by the management of the acquiree.

An important method of expansion for large UK companies is now via diversification or takeover activity abroad. This fact is evident from the increased proportion of diversifying acquisitions in recent years, which now account for almost one third of the transactions considered by the Office of Fair Trading. The decision to expand abroad, in particular into North America, is one which has been taken by a substantial number of larger companies in the last few years, and has been encouraged not only by limited prospects in the domestic market, but also by a combination of favourable circumstances in the United States.