Takeovers, buyouts and standards in the City

Discussing some of the main issues concerning takeovers and mergers in the United Kingdom, the ***Governor*** *examines*[1] *some of the questions they raise for company-shareholder relations, emphasising the advantages that could flow from more positive action from shareholders to influence or change management where circumstances warrant. He goes on to consider the conflicts of interest that arise in total management buyouts and the ideas being proposed for containing them, noting, in particular, the importance of strong independent representation on company boards and the role of the Takeover Panel in the debate. He comments also on the financing of leveraged transactions, and stresses that the banks need to exercise proper caution, and ensure that their involvement is commensurate with their expertise and takes account of the special scale and nature of the risks. Finally, he underlines the need for the highest standards in all the business conducted in the City, arguing that it is a vital task of management to develop and maintain a corporate ethos which supplies the answers to the fundamental questions of what is right or wrong in any given circumstance.*

It is a great pleasure to be here this evening, Mr Chairman, in this, your 10th anniversary year. It is a year in which you have made a notable contribution to a venture of considerable interest to the Bank—the development of the corporate bond market.

And for me personally it has almost been Corporate Treasurers' Year. It is not many months since I hosted the debate you arranged in the Bank on the pros and cons of contested takeovers. As you will recall, it was a rather lively affair, and the takeover market itself has hardly been less lively since then. This may owe something to one of the chief protagonists in the debate—Sir James Goldsmith—who has practised what he so forcefully preached, and in retrospect must have been planning to do so even as he spoke.

On that occasion my colleagues in the Bank observed Trappist rules. As the Chairman informed the debate: 'I have been asked to point out that the Bank of England does not support the motion, but that nor does it oppose it.' I therefore thought I might take advantage of your hospitality tonight to revisit some of the main issues concerning takeovers and mergers.

Contested bids, and company-shareholder relations

Perhaps the first thing to say is that there is no single correct way of organising corporate affairs or, more particularly, the market for controlling interests in companies. In some major and highly successful industrial economies—notably Japan and Germany—the stock market provides a means for raising capital and secondary market trading, but is not commonly used for mounting takeover bids. By contrast, over the past thirty years such bids have become an integral feature of the British scene. Indeed, the stock market provides the principal mechanism for transferring the ownership and control of UK public companies.

The takeover market has its detractors, but it undoubtedly has many positive characteristics. Thus, while British industry will be weaker in the long run if it does not place emphasis on sound organic or internally-generated growth, takeovers can contribute to growth and have a part to play in corporate strategies.

They do, however, raise important issues about shareholder-company relations. For example, the strategy of using acquisitions to diversify into wholly unrelated businesses raises the question of whether management should actively consider the alternative of making extra distributions to shareholders and allowing them to diversify *their* portfolios. Equally, however, shareholders tend not to insist on this alternative.

Indeed shareholders have often not had a major influence on strategic issues. Given that they have not been active in exercising the choices open to them—to assert their position as controllers of a company—many takeovers are in effect quite simply a means of transferring resources from weak to strong management teams.

Takeovers can be expensive to implement, however, and in consequence may not always be the most efficient way of securing a change of direction or strategy. A similar result could sometimes be achieved, at less cost, by changing the management, but for one reason or another, shareholders seldom take decisive action to ensure that a company's board is up to scratch.

If they responded sooner to poor performance by discussing the issues with the board, takeovers might not

(1) In a speech at the Association of Corporate Treasurers' 10th Anniversary Dinner, on 26 October.

be so frequent. Indeed, more generally, I believe business—and the economy as a whole—would be stronger if shareholders were closer to management and prepared in principle to take pre-emptive action to change management where the circumstances justified it.

Since the CBI task force examined the relations between the City and industry, both sides have, I believe, worked harder to understand each other. But managers of financial assets also have responsibilities to savers who seek not only an adequate return, but also continued evidence of good performance.

There is thus no easy resolution of the tension between these goals, but we need to go on trying to find one.

Total management buyouts

The same is true of a particularly difficult situation in which shareholders find themselves on the spot: that is, in a total management buyout—I mean by this a case where management wants to buy the whole of a company from its shareholders.

It is now widely recognised that the management team faces a severe conflict of interest in this situation. On the one hand, it is their duty—as quasi-trustees for the shareholders—to seek to obtain the highest possible price for the company's shareholders. On the other hand, as prospective purchasers, they naturally wish to get the best possible bargain—or, in other words, to pay the lowest possible price. These conflicts arise whether or not the MBO is made in response to an open market bid, although I should add that few problems arise when management is offering to buy only a discrete *part* of a business as then the main board generally remains free from conflicts.

Some critics are so concerned about this problem that they would bar an incumbent management from making bids. This would, however, risk reducing the considerable contribution which management-controlled companies can potentially make to the economy generally. Furthermore, there may be occasions when it would be in the best interests of shareholders for the existing management to take over the business. This is probably most likely when the management are particularly confident that they can improve the return on capital because of their knowledge of the business, and are accordingly prepared to pay the highest price. They may, after all, be willing to accept risks on their own behalf which they cannot take when they are answerable to a much larger group of shareholders. Indeed, recent events suggest that the company may sometimes be weakened in the process, and I shall discuss this later.

I do, however, agree with those who are concerned to ensure that shareholders receive adequate information. In an ordinary takeover, the bidder typically has far less information about the company than the board who look after shareholders' interests. In a total MBO, however, the tables are turned: the shareholders do *not* know as much as the executive management offering to buy their company.

The responsibility for advising shareholders falls of course on any non-executive directors on the basis of the advice they in turn receive from the company's professional advisers. The problem can therefore be acute if a company does *not* have any non-executive directors or if they are insufficiently independent. This emphasises again the importance of strong independent representation on company boards, and I urge all companies to follow the PRO-NED code, which has been endorsed by the Stock Exchange, the major City institutions and the CBI.

The general problem of conflicts in MBOs is being addressed by a number of market bodies. They are looking for ways to balance shareholders' rights with opportunities for management to unleash new energy.

It has been suggested, for example, that the conduct of MBOs should be covered by a special code or by guidelines and that shareholders should make compliance a condition of entertaining a management bid.

I believe that this and other ideas emerging from the market place deserve consideration. If they command support, it will be necessary to give careful consideration to how they might operate in practice, and in particular whether they could have implications for the general rules governing the conduct of bids. The Takeover Panel will therefore have an important role to play in this debate.

And more generally, since I am discussing the UK takeover scene this evening, I should take this opportunity of stressing the great strength of our Panel system, which has combined flexibility with robustness in responding to the rapid and major developments in the takeover market over the years. It has done more than any institution to ensure high standards of conduct and fairness for shareholders. And it is, I believe, therefore essential that we preserve the Panel's non-statutory status, even within the embrace of the European Community.

Financing of buyouts

Another issue raised by many MBOs is the manner of their financing, and this has to be seen in the broader context of leveraged buyouts, whether they are MBOs or not.

Arguments have raged on both sides of the Atlantic about the virtues and dangers of high gearing. The dangers are not seen to lie solely in junk bonds themselves, but rather in an overall financial package being more than a borrower can sustain.

On the whole I take the view that these questions are best left to markets. It would be only too easy to try to nanny companies and financial institutions, and in doing so to sap enterprise and restrain initiative. Moreover, there is nothing new in the notion that high yields should go with high risk.

This is not to deny that important issues can be raised by some LBOs. There could, for example, be legitimate concerns if competition in the relevant industry could be adversely affected through the failure of a company with an unsustainable financial structure resulting from a leveraged acquisition.

And one particular aspect of LBOs is of special interest to the Bank in its role as a bank supervisor. This is that the bulk of the finance in the first round comes from banks. As I stated at the Mansion House last week, we see little to suggest that bank exposures to leveraged deals, either individually or in aggregate, have so far reached worrying levels. They do, nevertheless, present risks of a different dimension from conventional credit transactions. We have therefore been watching them closely, and will continue to do so.

At this early stage in the cycle and before fashion takes over in the United Kingdom, individual banks should give careful consideration to the special nature and implications of LBO financing risks. First, they should satisfy themselves that they have the particular skills to participate in this market. And second, they should be setting themselves clear policy guidelines on acceptable levels of exposure to individual deals and to leveraged transactions in general. In this more than most areas, the rule must be that if you do not know what you are doing, *do not do it*.

For those banks which believe they do know what they are doing, the basic principles that should apply to LBO exposure policies are familiar enough, but they do need to take account of the special scale and nature of the risks and the importance of the assumptions underlying any deal being robust enough to withstand unexpected developments.

Caution should therefore be the rule of the day. It would be damaging to industry and to the financial sector in general—to say nothing of banks — if prudence does not guide the financing of leveraged transactions.

Standards in the City

Finally, I should like to turn to standards in the City.

Although MBOs, LBOs and mergers and takeovers generally have a particularly high public profile, it is of course essential that *all* the business conducted in the City of London—of whatever type—should be guided by the highest professional and ethical standards.

The complexity of our markets can make it harder to perceive and hold on to the fundamental questions of what is right or wrong in certain circumstances. It is therefore one of the vital tasks of management to develop and maintain a corporate ethos which of itself supplies the answers to such questions. This is an essential foundation for the efforts of the regulatory authorities, which provide systems and rules but cannot be a substitute for high standards in the firms themselves.

The intensification of competition in the City over the past few years has not made it any easier to maintain a high corporate ethos. And I should perhaps say that I am well aware that some people mourn the old City, and would hold that standards were higher then, and more easily enforced. I am not at all certain that I agree, and in any case there were patent inefficiencies that without doubt impaired the range and quality of services provided to the City's customers, both investors and borrowers and both domestic and international. But, whatever the strengths and weaknesses of the old system, there is no going back. The new system must establish its own reputation.