IMF COMMITTEE ON BALANCE OF PAYMENTS STATISTICS AND OECD WORKSHOP ON INTERNATIONAL INVESTMENT STATISTICS

DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

BACKGROUND PAPER # 4

The treatment of mergers and acquisitions (M&As) in direct investment statistics

The case of M&As involving an exchange of securities

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The treatment of mergers and acquisitions (M&As) in direct investment statistics

The case of M&As involving an exchange of securities

1 Background

1. Mergers and acquisitions are a means of achieving external growth very rapidly in sectors in which size is a crucial factor in the development and future profitability of a firm.

2. At a certain level of international competition, a major challenge for firms is to achieve a leading or even dominant position in a sector considered to have large potential for growth. To do so, requires considerable resources.

3. Few large firms are able to raise the necessary funds, either in the form of bank loans, loan issues or capital increases, without incurring additional financial costs that may jeopardise their profitability and financial situation.

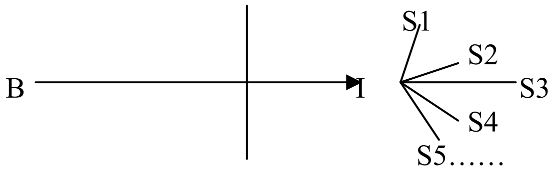
4. Often if not always therefore, it is for reasons of cost that today there are more friendly than hostile bids, that the number of mergers -- which eventually result in a transfer of assets -- is growing, and that payment tends to be in the form of securities rather than in cash.

5. The impacts, especially in the long-term, of this trend requires an analysis that lies outside the purely statistical framework of our work. Here we shall simply recapitulate how mergers and acquisitions are treated in direct investment statistics, with reference to the experience of the services of the Banque de France which are responsible for drawing up the balance of payments.

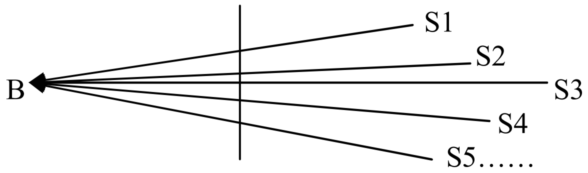
2. General principles governing the way M&As are recorded in the balance of payments

6. A M&A flow by a firm resident in country A, to a firm resident in country B, is always recorded in the balance of payments of country A, in its foreign direct investment.

7. When the transaction is paid for partially or totally in securities (usually listed), the off-setting entry will usually be made under **portfolio investment**, when the ex-shareholders of firm B hold less than 10 per cent of the share capital of A further to the transaction. An inward direct investment flow in the national economy may also be recorded whenever one of the ex-shareholders of firm B holds at least 10 per cent of the share capital of A.



Direct investissement (S = shareholder)



Portfolio investissement

3. Practical questions

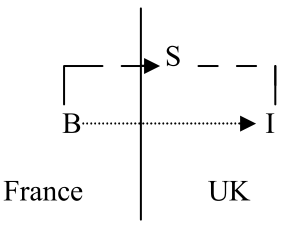
a) Identifying correctly the counterpart country so as to avoid international balance-of-payments discrepancies

8. Consider the following situation: a company S (British in the first case, German in the second case) sells off its subsidiary I in the United Kingdom, the purchaser being company A in France.

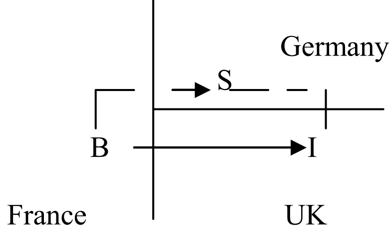
Case 1: when the country of the seller is also the country of the company being sold off , both countries record direct investment flows of the same amount but opposite direction.

Case 2: the situation is different when the payment is made to the country of the seller (S) and that country is different from the country of the company being sold off (I). The geographical allocation of the direct investment by the country of the acquiring company (B) is always according to the country in which the company being sold off is located. But most often the latter does not record any flow since, from its point of view, the transaction is between two non-residents. There is thus the risk of a discrepancy in the balance of payments which can be avoided only if information is exchanged between countries or by annual surveys of stocks of direct investment.

Case 1



Case 2



9. This being so, even though the 5th IMF Balance of Payments Manual does not require it, the country of the company being sold off should simultaneously record a disinvestment and an investment,

respectively with the country of the company selling the subsidiary, and with the country of the company acquiring it.

b) Identifying the securities constituting the payment, in order to ensure that portfolio investments are recorded properly

10. A statistical information system based on bank payments captures cash transactions.

11. But when a merger involves the exchange of securities, the payment is in the form of securities, which most often are shares in the buyer. The shareholders in the target company exchange their shares for shares in the buyer, according to the terms of exchange that have been decided.

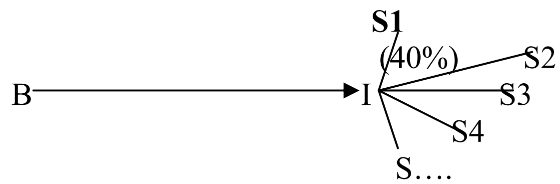
12. In order to ensure that the counterpart of the direct investment transaction is recorded in full in portfolio investment, it is important to determine exactly the amount and origin of the securities of the investing company, that constitute the payment:

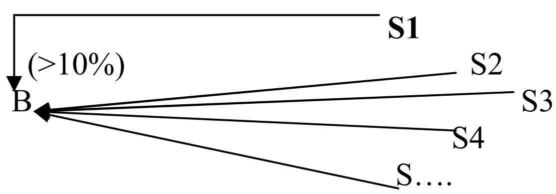
- Shares held by the company itself i.e. self-controlled;
- Securities sold by a group of shareholders in the company making the investment;
- A capital increase reserved to shareholders in the target company who have provided their shares (in this case, a new share issue is involved).

c) Analyse the nature of the offsetting investments made by the seller (s) so as to ensure that portfolio investment is clearly distinguished from any direct investment.

13. It may be useful, and indeed necessary, to examines flows from the country in which the target company is located in order to ensure that investments offsetting the direct investment transaction are recorded properly; in particular, it is necessary to check whether the return investment flows include acquisitions of stakes of over 10 per cent in the investing company, taking into account any new share issues.

14. If this is the case, as a result of the exchange of securities, the investing company becomes in its turn a company which is invested in.





Annex

Example of the way mergers and acquisitions are recorded in the French balance of payments

The creation of Aventis by a merger between Rhône-Poulenc and Hoechst

Legal set-up

As provided by the merger agreement between Rhône-Poulenc and Hoechst:

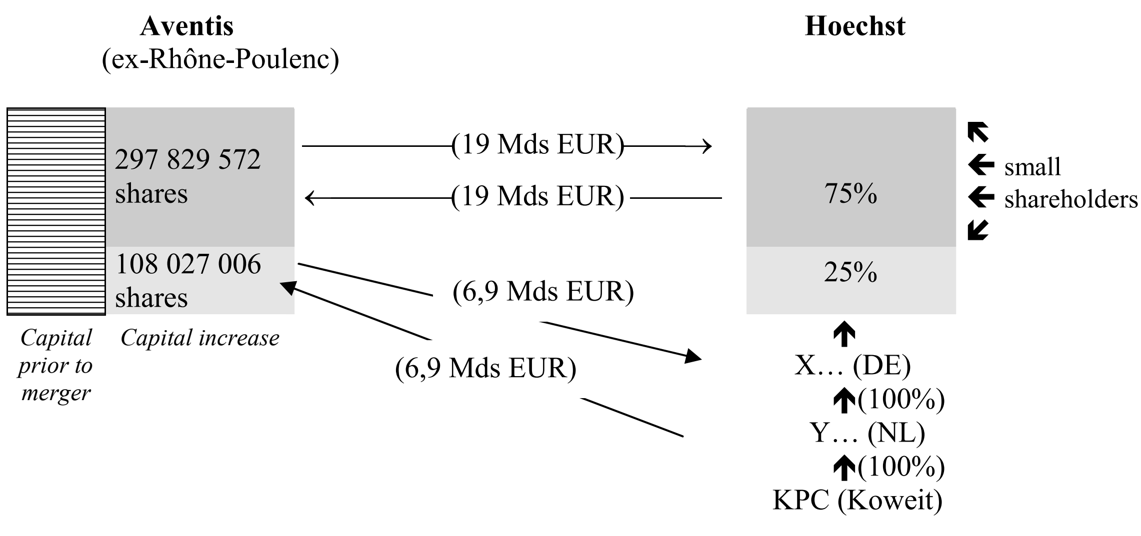
- The new company was established in France under the name Aventis; this means that **Rhône-Poulenc** had the role of the **acquiring company** even though the majority of the capital of the new Franco-German group was held by former shareholders of Hoechst, and thus by Germans;

- The acquisition was financed **exclusively by an exchange of securities further to an increase in the capital of the acquiring company,** thereby increasing the stock market value of the new group and avoiding recourse to borrowing; **no cash payment** was made;

- Rhône-Poulenc, the "acquirer", launched a public exchange offer for **75 per cent of the shares of Hoechst,** the "target: (on the basis of 3 Rhône-Poulenc shares for 4 Hoechst shares); the offer was aimed at the public, essentially small shareholders and a few large core shareholders in Hoechst; once the results of the offering were known, Rhône-Poulenc made a large capital increase to create the shares needed to pay for the offer;

- The control of a block of 25 per cent of Hoechst's shares held by the Koweiti group KPC (via X, a German subsidiary of KPC via the company Y established under Dutch law), passed directly to Rhône-Poulenc in exchange for Aventis shares newly issued for the company Y, acting on behalf of KPC.

Aventis (ex-Rhône-Poulenc), the initiator of the public exchange offer, is **a French resident company** taking over a German company**. From the legal and accounting standpoint, therefore, it constitutes a French direct investment in Germany**.



Way in which the merger was recorded in the French balance of payments:

- **Outward direct investment (Germany) in equity**

  Flow (expenditure) of 25.9 billion euros (increase in claims)

- **Offsetting investment:**

  – **Portfolio investment in French shares:**

    Flow (receipts) of 19 billion euros (increase in liabilities)

    Aventis shares received by Hoechst's small shareholders as part of the public exchange offer

  – **Inward direct investment (from the Netherlands) in equity**

    Flow (receipts) of 6.9 billion euros (increase in liabilities);

    Stake taken by Y …, the Dutch company, in Aventis.

If the merger had been initiated by the German side, with Hoechst making a public exchange offer for Rhône-Poulenc's shares, a German direct investment in France, and an offsetting portfolio investment in the German shares, would have been recorded. From the standpoint of the euro-area balance of payments, the globalisation aspect of the merger would have been the same.