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

DIRECT INVESTMENT TECHNICAL EXPERT GROUP (DITEG)

ISSUES PAPER #4

MERGERS AND ACQISITIONS (M&As)

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1. Mergers and Acquisitions (M&As)[1]

2. Current international standards for the treatment of M&As

1. IMF *Balance of Payments Manual, 5th edition* (*BPM5*) and the OECD *Benchmark Definition of Foreign Direct Investment* (*Benchmark Definition*) do not provide recommendations to distinguish different types of direct investment. FDI can be in three forms: (i) cross-border mergers and acquisitions; (ii) greenfield investments; and (iii) an extension of the capital of established direct investment enterprises. The subject of the present document is cross-border M&As and the latter two will be dealt with in separate documents.

3. Concerns/shortcomings of the current recommendation

2. Main shortcomings and concerns are related to the absence of recommendations and international standards:

(a) Analytical shortcoming considering the significant share of M&As in FDI activity world-wide. The impact of M&As on home and host economies differs from the impact of other types of investments, in particular of greeenfield investments;

(b) There is no agreed coverage and definitions of M&As;

(c) There are no (or very few) M&A data comparable to consistent with FDI statistic;

(d) Lack of guidance for recording individual transactions and their classification.

3.1 Rationale and analytical relevance of M&A statistics

3. M&As account for a very large share of FDI. Initially significant in the United States, M&As have become a wide-spread feature of European and emerging economies. As the barriers to trade and investment were lifted and global economic integration grew, the international dimension of M&As has developed dramatically in the corporate restructuring of enterprises, including the improvement of performance, meeting financial requirements, etc. Restructuring can be conducted in several phases, starting at the national level followed by cross-border operations.

4. Companies go cross-border to access the most competitive and efficient markets. There are various other favourable factors which attract business: convergence of consumer needs and preferences; better opportunities to recover costs generated by research and development (R&D); availability of capital and the financial innovations providing additional financing facilities; new opportunities as a result of privatisation of state-owned enterprises. However, the opening of markets (cross-border) added a higher risk factor for business failures as the players may not master the conditions as well as they could have done for domestic operations.

5. The business strategy of the company designs the objectives of M&As. For example, the acquirer may have a strategy for the improvement of the productivity of the target company through efficiency gains. In other cases, the acquirer may have a strategy for diversifying its activities in unrelated business to minimise its risk exposure rather than creating profits for shareholders. Generally, the main motivation of M&A is the improvement of profits and efficiency through a new business combination. The immediate objective is the growth and expansion of the company with

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1 . See also an issues paper prepared by Canada on the same subject.

regard to its assets, shares and market share[2]. The ultimate objective is the maximisation of profits and the achievement of sustainable competitive advantages.

6. Most common strategic motivations of M&As are: (i) to achieve growth by opening up to market opportunities as compared to small domestic markets; (ii) to access raw material, innovations, technology, cheap and efficient labour, etc.; (iii) to benefit from exclusive advantages such as company reputation, its brand or design, production, management, etc.; (iv) to manage risk by diversifying products and markets, by reducing dependence to local expertise, to avoid prohibitive policy and/or regulation in home country, to escape economic instability, etc.; (v) to take opportunities which offer favourable conditions; (vi) to respond to clients' needs with services from overseas subsidiaries, such as banking and accounting.

7. M&As can generate economic gains by business expansion. They allow (i) the transmission of complementary skills, such as management or technical skills; (ii) increased "market power" and access to new market segments; (iii) economies of scale (particularly in manufacturing sector), i.e. lowering the costs through the production of larger volumes; (iv) to improve the use of capital equipment as result of an increase in the specialisation of labour and management; (v) to obtain more rapidly a good reputation and a critical size on the market, which will require more time and resources for a new company.

8. As far as financial aspects are concerned, M&A transactions may facilitate the consolidation of asset management and provide better means and reputation to access to financial markets. Large companies are considered as less subject to risk which may have a favourable impact on the cost of borrowing of the firm.

9. There may be tax incentives to conduct M&As. Taxation can have a significant role in the structuring of the M&A operation once a deal has been identified. It is useful for a firm to focus on specific fiscal aspects of the transaction to be able to identify cost advantages and the possibility to minimise the liabilities.

3.2 M&A data availability and coverage

10. There are only a very few OECD countries which include M&A statistics within their official data collection and dissemination[3]. Most of M&A data are compiled by private commercial data sources which have the merit for providing usually very timely data with a wide coverage. However, the underlying purpose of for compiling these statistics is not to analyse the FDI activity. They complement business statistics and relate to the overall capital of enterprises rather than the transactions which qualify as either domestic or cross-border operations.

11. OECD Secretariat published in "Recent trends and developments" (2002) detailed M&A data along with FDI statistics. Presenting such data in the same article evoked the criticism of certain national experts of FDI statistics even if the article cautioned the reader to the incompatibility of two sets of data (FDI and M&As)[4]. On the other hand, the article received ample solicitation from the

2. Market share: The total number of units of a product (or their value in a given currency) expressed as a percentage of the total number of units sold by all competitors in a given market.

3 . The United Kingdom is one of the rare countries falling in this category. A background document "Mergers &Acquisitions: Mini-review, 2003" describes these statistics and provides very useful information.

4 . See Annex 2 for the description provided in the OECD. *International Investment Perspectives - 2002*

public, demonstrating its support in favour of including M&A analysis when discussing FDI developments.

12. M&A is a generic term covering various types of business combinations. All existing statistics, private and /or official, do not necessarily relate to the same categories. Annex 1 includes a proposed glossary for the consideration of experts.

4. Alternative treatment

4.1 A new proposal for FDI statistics

13. The proposal is to expand FDI statistics to classify by type of FDI: (i) Cross-border M&As; (ii) greenfield investments; (iii) extension of the capital of established direct investment enterprise.

14. The proposal for cross-border M&As relates to:

(i) Financial flows; i.e cross-border M&As as a sub-category of total FDI capital flows (it does not relate to FDI income and to FDI position data);
(ii) Breakdown by partner country;
(iii) Breakdown by industry;

15. It is necessary to establish a list of types of business combinations, including definitions and descriptions, which qualify as M&As. The terms *mergers, acquisitions, consolidations* and *take-overs* are usually used interchangeably. Differences between these forms of business combinations lie mostly in the legal nature of the resulting entity.

4.2 Recording M&As

16. Recording cross-border M&A involves, for many operations, more than one component of the balance of payments and all the transactions are not always necessarily either domestic or cross-border. Recommendations should provide clear guidance to compilers.

An example.

Case of a cross-border merger where Company B [resident of New Zealand] becomes a subsidiary of Company A [resident of the United Kingdom]

Acquiring company: Company A
Target company: Company B
The overall cost of the operation for Company A is $190 m:
- $ 150 m.[market value] to purchase the shares of Company B
- $ 40 m for other expenses including a premium for shareholders

To finance this operation Company A will increase its capital by issuing new equity and bonds on the international market for $190 m
- $180 m. of new equities of which $165 m will be set aside for the shareholders of company B [as payment for $150 m plus $15 m premium] and $15 m for other foreign investors.
- $10 m of bond of which $6 m will be on international markets and $4 m on the domestic market.

Company A will own all the shares of Company B;
The shareholders of Company B become shareholders of company A but their holdings represent less than 10 % of the shares of Company A.

Remaining equity [$15 m] is purchased by French and Japanese investors, $5 m and $10 m respectively;

The statistical recording in the balance of payments
In US$ million

	Balance of payments of United Kingdom	Balance of payments of New Zealand	Balance of payments of Japan	Balance of payments of France
Direct investment abroad	-165			
Direct investment from abroad		165		
Portfolio investment in foreign securities		-165	-10	-5
Foreign portfolio investment in domestic securities	165+10+5+6(*)			

(*) $180 m in equity securities and $6 m in international bond issues. $4 m domestic bond issues are not accounted for in the balance of payments but will be included in the flow of funds of the United Kingdom.

17. More and more M&As are arranged by exchange of securities as opposed to cash payments, a feature most common in big operations. For example, the ex-owners of the acquired company (direct investment enterprise) become shareholders of the acquiring company (direct investor). Recording such operations may be complicated for complex operations. The reader is referred to a background document prepared by Banque de France[5] which discusses payment by exchange of securities.

5. Questions for discussion

Q1. DITEG is invited to discuss the possible extension of FDI statistics to provide additional breakdown by type of FDI, namely cross-border M&As, greenfield investments and extension of the capital of established enterprises.

Q2. What are the comments of the experts on the experience of the United Kingdom described in a dedicated background document?

Q3. What are the comments of experts regarding the definitions in Annex 1 : glossary?

Q4. Do experts agree with the proposal for the statistical treatment described above under "4. Alternative treatment"? Do they agree with the treatment described by the background document by France on the exchange of securities?

Q5. If it is recommended that M&As be a part of the official statistics , DITEG is invited to make specific proposal for the preparation of a comprehensive documentation, for IMF Balance of Payments Manual and the OECD Benchmark Definition of Foreign Direct Investment definitions.

5. Background document by Banque de France: "The treatment of M&As in direct investment statistics: the case of M&As involving an exchange of securities".

Supplementary information:

Annex 1. Glossary

An ***acquisition*** is a business transaction between unrelated parties based on terms established by the market where each company acts in its own interest. The acquiring company purchases the assets and liabilities of the target company. The shareholders of the target company can no longer claim any ownership. In some cases, the target company becomes a subsidiary or part of a subsidiary of the acquiring company;

(i) A ***take-over*** is a form of acquisition where the acquiring firm is much larger than the target company. The term is sometimes used to designate hostile transactions.

(ii) A ***reverse take-over*** refers to an operation where the target company is bigger than the acquiring company. However, mergers of equals (in size or belonging to the same sector of activity) may also result in a hostile take-over.

Divestment refers to the selling of the parts of a company due to various reasons : a subsidiary or a part of a company may no longer be performing well in comparison to its competitors; a subsidiary or a part may be performing well but may not be well positioned within the industry to remain competitive and meet long-term objectives; strategic priorities of a company to remain competitive may change over time and lead to divestment; loss of managerial control or ineffective management; too much diversification may create difficulties thus lead the parent company to reduce the diversification of its activities; the parent company may have financial difficulties and may need to raise cash; a divestment may be realised as a defence against a hostile take-over.

Corporate divestment can be conducted in different ways.

(i) *Corporate sell-off*: in most cases buyers are other companies.

(ii) *Corporate spin-offs:* the divested part of the company is floated on a stock exchange. The newly floated company is separately valued on the stock exchange and is an independent company. The shares in the newly listed company are distributed to the shareholders of the parent company who thereafter own shares of two companies rather than one. Through such an operation they increase the flexibility of their portfolio decisions.

(iii) *Equity carve-out* is a partial divestment; it is similar to corporate-spin off but the parent retains the majority control. This form has the advantage of raising cash for the divestor.

(iv) *Management buy-outs (MBO) and buy-ins (MBI):* Sometimes the buyer is the manager of the company that is being sold off. In the case of an MBI, a private company is bought by the management.

A ***merger*** is the combination of two or more companies to share resources in order to achieve common objectives. A merger implies that, as a result of the operation, only one entity will survive. There are three types of mergers: *statutory mergers, subsidiary merger and consolidation.*

(i) ***Statutory merger*** relates to the business combination where the merged (or target) company will cease to exist. The acquiring company will assume the assets and liabilities of the merged company. In most cases, the owners of merged companies remain the joint owners of the combined company.

(ii) ***Subsidiary merger*** relates to an operation where the acquired company will become a subsidiary of the parent company. In a reverse subsidiary merger, a subsidiary of the acquiring company will be merged into the target company.

(iii) ***Consolidation*** is a type of merger which refers to a business combination whereby two or more companies join to form an entirely new company. All companies involved in the merger cease to exist and their shareholders become shareholders of the new company. The terms consolidation and mergers are frequently used interchangeably. However, the distinction between the two is usually in reference to the size of the combining companies. Consolidation relates to an operation where the combining firms have similar sizes while mergers imply significant differences**.**

Mergers are usually referred to as *horizontal, vertical* or *conglomerate* mergers.

(a) A ***horizontal merger*** occurs when two competitors combine, i.e. two companies having the same activity (e.g. two companies in defence industry). Such a combination may result in an increased market power for the merged company and, consequently, may be opposed by antitrust regulators.

(b) A ***vertical merger*** is the combination of two companies with complementary activities such those having a buyer-seller relationship (e.g. an operation between a pharmaceutical company and a company which specialises in the distribution of pharmaceutical products).

(c) A ***conglomerate merger*** relates to all the other types of transactions, i.e. when two companies do not have a specific relationship and are usually in different lines of business (e.g. a tobacco company merging with a food company).

Strategic alliances are arrangements or agreements under which two or more firms co-operate with a view to achieving commercial objectives. As an alternative to M&As failures, companies have explored other business combinations. However, the objectives of strategic alliances and M&As are different. Strategic alliances are not outright acquisitions and their forms can vary between simple agreements between firms up to the creation of separate and legal entities.

A ***joint venture*** is a well know form of strategic alliance which involves two or more companies with legally distinct structures investing in an entity and, consequently, participating in its management. Motivations for such alliances are cost reductions, sharing technology, product developments, market access or access to capital. If strategic alliances are properly structured, they can be less costly than acquisitions. The underlying assumption is that if two or more companies pool their resources, joint objectives can be achieved more easily and more economically.

Strategic alliances can be terminated much more easily than M&As considering structural and legal commitments. However, the success of strategic alliances is not estimated to produce as successful results as expected.

Annex 2. Extract from International Investment Perspectives, 2002, OECD

Box. 2 M&A Data: Sources and Definitions

The mergers and acquisitions data used in this article were made available for the purpose of this article by the global investment banking analysis company Dealogic on the basis of their M&A Global Database. The definitions applied to the data collection are the following:

Inclusion criteria:

1) Acquisitions, mergers and disposals. All transactions are included, of both public and private companies. Included are public offers; open market purchases; stock swaps; going-private deals; reverse takeovers; share placements; recapitalisations; and buy-outs.

2) Acquisitions of assets. Asset purchases are covered and include business divisions and operations; restaurants, pubs, hotels, casinos and other leisure industry assets; shopping centres; newspapers and periodicals; airports and ports; telephone, cellular and wireless licenses; pharmaceutical distribution rights; and hospitals, nursing homes and other medical care facilities.

3) Stake purchases. All stake purchases of 5 per cent or above in both public and private companies are covered wherever possible. The acquisition or disposal of lower stakes may also be included where the stake purchased or sold is considered to be of strategic importance.

4) Spin-offs, split-offs and equity carve-outs. Demergers including privatisations are covered.

5) Share buy-backs. Share buy-backs are included or excluded according to the following criteria. Public tender offers and buy-backs as divestments are covered; likewise buy-backs employed as a defensive technique are covered. Other buy-back programmes are included if they are for the repurchase of stakes greater than 10 per cent or, lastly, if the value of the programme is greater than USD 50 million.

6) Joint ventures. Strategically important joint ventures are covered. Transactions where existing assets or businesses are being acquired by, or merged into, a joint venture will be included. As a rule, the creation of new companies to pursue joint venture interests is not covered.

Exclusion criteria:

1) Alliances or agreements. Strategic alliances (not identified as joint ventures); distribution, contract and customer purchase agreements; and leases are not considered for inclusion. Likewise purchases by companies of products manufactured by another company are not considered.

2) Financial instruments. The following instruments are not included in the database: options, rights, warrants, debt instruments (e.g. subordinated notes), private placements other than private equity transactions, and loans. Placements of shares, whether primary or secondary, are not included unless they meet the criteria for divestments or privatisations.

3) Patents and copyrights.

4) Restructurings. Transactions considered as the merger of one company's wholly owned subsidiaries are classified as a restructuring exercise, and as such are not included.

18. Additional information, as well as commercial access to Dealogic's comprehensive databases, can be obtained from the website www.dealogic.com.

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