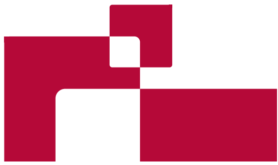

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FOREIGN TAKEOVERS NEED CLARITY FROM EUROPE

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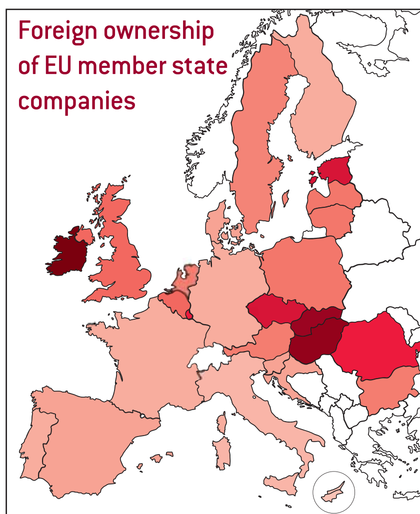
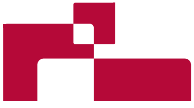
THE ISSUE Foreign takeovers are often a source of concern for national governments. Concerns might be of a strategic nature (for example in cases of deals in the defence sector) or of a more economic nature. In these cases, the public perception is often that a foreign investor, being less physically or psychologically attached to the host country, could more easily take decisions that would harm the economy, such as downgrading the acquired company's brand or cutting jobs or research expenditure. However, the only consideration in merger assessment that matters for the European Commission, which is responsible for cross-border merger control in the EU, is whether the merger will harm consumers. Member states can intervene only in exceptional circumstances.

POLICY CHALLENGE

This policy brief raises two questions about foreign takeovers: (1) is the likelihood of domestic welfare loss greater when a foreign investor buys a national company? (2) are economic concerns legitimate reasons that could justify interference by member states in the European Commission's current approach to cross-border mergers? A thorough analysis of the literature suggests that the answer to both questions is no. Granting leeway to member states is unnecessary and potentially harmful, given the increased uncertainty about outcomes. In order to increase transparency and stimulate foreign investment in Europe, the Commission should clarify the parameters of permissible intervention by member states.



Source: Bruegel based on FATS/Eurostat. Note: darker shading indicates a higher ratio of turnover of companies with non-domestic ownership, compared to turnover of companies with domestic ownership, ranging from 12% (Cyprus) to 123% (Ireland). Data for Malta and Greece is missing. See Table 1.



IN 2010, when United States food group Kraft purchased British chocolate maker Cadbury, the takeover was in part facilitated by an undertaking from Kraft that it would reverse a Cadbury decision to relocate some production from the United Kingdom to Poland. After the merger, however, Kraft went ahead with the plan to move production to Warsaw.

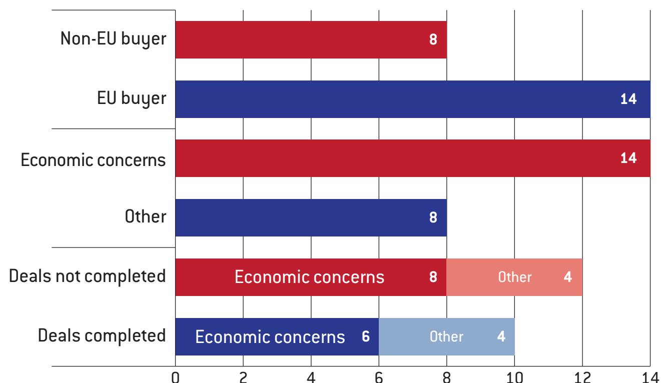
Such events can make politicians wary of foreign takeovers. In the UK, similar concerns arose in spring 2014 when US company Pfizer attempted to buy Britain's AstraZeneca. The UK government's concern was to avoid loss of R&D jobs following the deal. In this case, however, Pfizer ultimately dropped its offer and the merger did not take place.

Calls for government intervention to protect the public interest when a foreign investor attempts to buy a national brand are frequent in Europe. However, mergers of significant size that involve companies of different origins, whether EU or non-EU companies, are normally subject to scrutiny by the European Commission in its role of antitrust authority[1] and national governments are not supposed to play a role. This might create some inter-institutional tension since the guiding principle followed by the Commission during its merger assessments is to uphold the interest of the consumer only, while national government might pursue other interests. No other criteria can affect the Commission's decision. For example, rationalised production, reduced marginal costs of production and consequent lower market prices might be sufficient conditions for merger clearance. That the rationalisation might also entail redundancies is not relevant to the Commission's assessment. This does not mean that the Commission believes that these are negligible issues that should be ignored. Rather, it is believed that in such situations other institutional instruments (such as redistribution and employment policies) are more appropriate than antitrust control.

In certain cases – when the merger affects public security, plurality of the media or prudential rules – national governments are allowed to intervene and to impose conditions on mergers that fall under the Commission's jurisdiction (Article 21 of the European Union Merger Regulation, EUMR; see also Röller and Véron, 2008, for a thorough discussion of security concerns in merger control).

National concerns are often of a presumed economic nature. There is a general perception that a foreign investor would be less physically or psychologically attached to the host economy, that it would be easier for the foreign investor to close down the headquarters of the acquired company, that the foreign investor could have an interest in downgrading national brands that compete on the same markets or that it would be less sensitive to trade-unions or to political pressure to preserve jobs in the country. Such views can become even more prevalent in time of economic crisis. And the EUMR does not fully close the door to action by national government. In addition to public security, plurality of the media and prudential rules, the Commission may recognise other 'public interests' as legitimate if compatible with the principles of EU law.

Figure 1: Number of major EU cross-border mergers in which buyer's nationality triggered government intervention (1999-2014)



Source: Bruegel. Note: cases in the sample were identified through a review of the literature on foreign takeovers and merger control in Europe. Because sometimes those cases are not explicitly publicly reported, the list is not exhaustive. The sample includes the following cases: BSCH/A.Champalimaud, Secil/Holderbank/Cimpor, Thomson-CSF/Racal, Novartis/Aventis, ABN Amro/Banca Antonveneta, BBVA/BNL, Unicredito/HVB, Danone/PepsiCo, Enel/Suez, E.ON/Endesa, Abertis/Autostrade, Mittal/Arcelor, Gazprom/Centrica, MAN/Scania, Enel/Acciona/Endesa, AT&T/Telecom Italia, Air France-KLM/Alitalia, Kraft Foods/Cadbury, Lactalis/Parmalat, Edison/EdF, GE/Alstom, Pfizer/AstraZeneca. Economic concerns are identified if concerns about the effect of the merger on productivity, jobs or R&D by key players such as members of the government, the national parliament or trade unions were reported in the contemporary media.

1. Article 1, Council Regulation (EC) No 139/2004 of 20 January 2004 on the control of concentrations between undertakings (abbreviated to EUMR). The Commission has jurisdiction over mergers of 'community dimension'; mergers do not have community dimension if all involved undertakings have more than two-thirds of their aggregate EU turnover within a single member state.

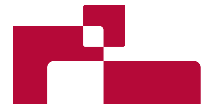


Figure 1 shows the number of major attempted cross-border deals in the EU in the last 15 years, in which the buyer's nationality prompted government intervention. In 14 out of 22 cases, economic concerns (such as fears about job cuts or productivity losses) played a role. In most cases over which economic concerns were expressed, the merger ultimately did not take place. While a direct causal link between economic concerns and a deal's outcome cannot always be made (buyers might simply drop an offer because they do not reach an agreement on the price, for example), the public debate around the buyer's nationality can significantly affect the process and can lead to delays, additional costs or specific commitments to be fulfilled by the parties, reducing the business appeal of a potentially valuable transaction.

However, there is a lack of clarity about the boundaries of government intervention in foreign takeovers. It is unclear what could be considered 'legitimate public interests' by the Commission, and governments often succeed in influencing the process, even if the compatibility of their intervention with EUMR is questionable. For example, governments can frustrate a deal by threatening to interfere with the merger: companies might be not willing to wait for the Commission to assess whether the action of the government is 'legitimate', or to see if the Commission will challenge the member state's interference before the European courts[2].

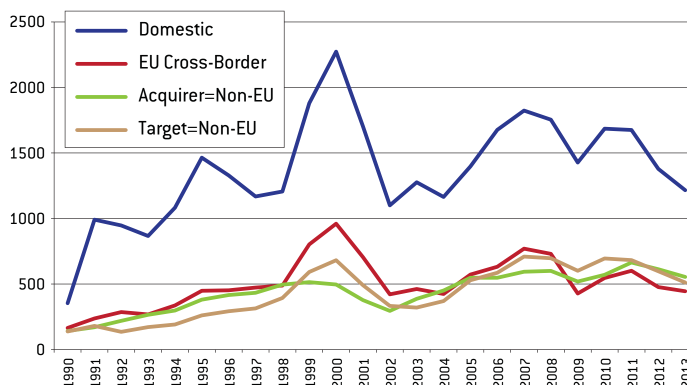
This policy brief asks the question of whether concerns of economic nature should be considered 'legitimate' grounds for national intervention in foreign takeovers. We consider the evidence about the economic effects of foreign takeovers, the potential costs of government interference above and beyond what is explicitly allowed in the EUMR, and conclude with some recommendations about how the EU framework can be made clearer.

ECONOMIC EFFECTS OF FOREIGN TAKEOVERS

Foreign direct investment (FDI) can take two forms: greenfield investment, or the establishment of new companies in the host economy; and merger & acquisition (M&A), or investment in existing companies. Developed economies attract FDI mostly in the form of M&A: approximately 60 percent in 2011 (UNCTAD, 2013)[3]. FDI thus partly involves a loss of control over domestic companies to the benefit of foreign investors[4]. Figure 2 compares EU28 cross-border and domestic M&A trends when the deal implied the acquisition of a majority stake in a target company. Acquisitions by European companies peaked in 2000, reaching comparable levels to merger activity in the US (acquisitions by US companies peaked three years earlier, partly explaining why the line representing acquisitions by non-EU companies has a smoother shape). In the last 25 years, mergers between companies from the same EU country represented half of the total merger deals, while 18 percent were cross-border mergers within the EU. The remaining deals involve non-European companies. Notably, as of the start of the crisis in 2008, EU cross-border merger deals tended to be fewer than deals involving non-EU companies, reversing the past tendency of per-year EU cross-border deals often outnumbering non-EU deals.

EU companies tend to be purchased by non-EU companies as much as EU companies acquire non-EU ones, ie in 16 percent of cases. Not surprisingly, though, cross-border mergers tend to be larger in size; therefore their relevance ramps up if the comparison is made on the basis of deal value: on average, cross-border deals within EU are 71 percent bigger than domestic mergers, and cross-border extra-EU deals

Figure 2: Number of merger deals in the EU, 1990-2013

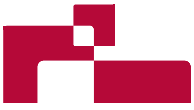


Source: Bruegel based on TR One database.

2. In E.ON/Endesa, for example, the Spanish energy regulator imposed a number of 'public interest' conditions to clear the merger, including a commitment by E.ON to maintain Endesa's headquarters in Spain. The European Commission challenged the decision of the Spanish authorities at the European Court of Justice, which ruled that Spain was in breach of EU law. However, the judgement was handed down more than two years after E.ON had started the acquisition process. During that period, E.ON dropped the merger offer.

3. UNCTAD, *World Investment Report* statistics 2013, page 67, tables C and E, http://unctad.org/en/PublicationsLibrary/wir2013_en.pdf.

4. We consider mergers resulting in a change of control, and do not consider simple changes in the composition of share portfolios. We consider a 'domestic merger' to be a merger in which control of a company passes from a resident investor to another resident. A 'cross-border merger' is a merger in which control passes from a resident investor to a foreign investor.



are 41 percent bigger than domestic mergers. Foreign-owned companies make a significant contribution to the European economy's turnover. In 2010, foreign-owned companies accounted for 40 percent of total turnover growth in Europe between 2010 and 2011. Within the single market however there is a high degree of heterogeneity in terms of the presence of foreign companies on member states' territory (Table 1).

The main lesson that can be drawn from the theoretical and empirical literature, however, is that there is no clear-cut indication that foreign takeovers are systematically beneficial or harmful to host economies. Fear and enthusiasm before a foreign takeover can be equally misplaced and a neutral stance would seem the most sensible approach to assessment.

We define 'economic effects' as effects on companies' performance (measured as productivity levels), employment and R&D efforts: these, broadly speaking, are the major economic issues that are a source of concern when a foreign takeover takes place[5]. Our brief literature review, below, focuses on these.

Multinational companies: A first insight from the literature is that multinational enterprises (MNEs) by their very nature tend to be efficient and to have a flexible approach to employment. Helpman *et al* (2004) find that MNEs enter foreign markets through FDI instead of through exports because they have lower marginal costs of production that can offset the extra sunk costs needed to set-up foreign affiliates and operate them in a less-known environment. This explains why foreign subsidiaries tend to be more productive than companies that are only active on domestic markets. MNEs are also found to transfer their 'superior' production technology and management culture to acquired subsidiaries (see for instance Bloom and Van Reenen, 2010), while no clear-cut evidence for positive spillovers onto competitors in the host economy is found (see Lipsey and Sjöholm, 2005, for a survey). A few papers find that employment in foreign MNEs can be more volatile, because foreign companies can respond with greater flexibility to changes in host countries' labour markets (Meriküll and Rõõm, 2014, find that such employment volatility might depend on the institutional environment in companies' host and home countries). But differences between companies' performances can be down to the scope of their activity rather than their origin: Hakkala *et al* (2010), for example, found that multinational firms have a significantly more elastic labour demand in Sweden, but they found no difference between foreign and domestic firms.

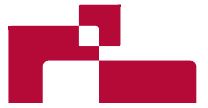
Selection of domestic targets: The empirical evidence strongly supports that companies acquired by foreigners have higher productivity and innovation levels. But a majority of papers, particularly recent ones, indicate that the higher average productivity of acquired firms is a result of a selection process and is not necessarily down to technology transfer from parent companies. In comparison to domestic buyers, foreign buyers tend to 'cherry pick' higher productivity national companies (see, for example, Griffith *et al*, 2004, for an analysis of UK data). A convincing explanation of cherry picking is provided by Guadalupe *et al* (2012) using data from Spanish manufacturing companies. Guadalupe *et al* found a complementarity between targets' initial productivity and foreign companies' ability to invest in innovation. A MNE can bring lower innovation costs through easier access to capital, or increase the

Table 1: Turnover of companies with non-domestic ownership as % of turnover of domestic firms, 2011

Country	Turnover ratio
Ireland	123%
Hungary	113%
Slovakia	109%
Estonia	88%
Czech Rep.	84%
Romania	77%
Luxembourg	75%
Belgium	61%
UK	61%
Latvia	58%
Poland	58%
Lithuania	57%
Bulgaria	54%
Austria	53%
Netherlands	53%
Sweden	49%
Croatia	34%
Denmark	33%
Slovenia	32%
Spain	31%
Germany	27%
Portugal	27%
France	25%
Finland	24%
Italy	20%
Cyprus	12%

Source: Bruegel based on FATS/Eurostat. Note: data for Greece and Malta is missing. Turnover ratio is the turnover of companies with non-domestic ownership over the turnover of domestically-owned companies.

5. Other sources of concern that are not directly linked to the nationality of the acquirer are not discussed. For example: transfer-pricing may allow an acquirer to allocate taxable revenue to different subsidiaries in different countries. This concern is however equally valid when a domestic company is the target or the acquirer of a foreign company.



benefits of innovation through greater output. For that reason, the value of an innovative company is greater if purchased by a MNE than if purchased by another domestic company. Similarly, Blonigen *et al* (2014) reported evidence that suggests that foreign buyers tend to acquire French companies with strong prior export behaviour and recent productivity drops ('cherries for sale'). Targets that established an export network during a high productivity period and that are later unable to serve the network are good takeover deals. Such a network is particularly valuable for a foreign acquirer, because they get access to markets they could not access before.

Acquired companies' *ex-post* performance: When discounting for this selection effect (ie taking into account that foreign-owned companies would be good performers regardless of the origin of the owner), there are mixed results in terms of the effect of foreign ownership on companies' productivity, employment and innovation. Recent empirical papers that focused on European countries include:

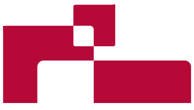
- *Effects on productivity:* Griffith *et al* (2004) found very small improvements in labour productivity and mixed evidence on investment per employee. Benfratello and Sembenelli (2006) using data on Italian firms found a positive effect only if the productivity gap between the foreign acquirer and the target is significant. Bertrand and Zitouna (2008) found significant increases in productivity after takeovers of French manufacturing firms by non-EU acquirers.
- *Effects on employment:* Huttunen (2007) found that workers in Finnish foreign-controlled companies experience higher wage growth after a takeover; Lehto and Böckerman (2008) found that cross-border (and domestic) M&As led to downsizing of manufacturing employment in Finland. Bandick and Görg (2010) used a dataset of Swedish firms and found that foreign takeovers have no or, if anything, a positive effect on plants' survival chances or employment growth.
- *Effects on R&D expenditure:* Guadalupe *et al* (2012) found positive and persistent effects on process innovation because of foreign takeovers, particularly when the parent firm provides access to export markets. Stiebale and Reize (2011) and Stiebale (2013) using German data, found instead a reduction of R&D expenditure by target firms in host economies and an increase in domestic R&D by foreign acquirers in the country of origin; this would be due to relocation of innovation activities to acquirers' headquarters.

Generally speaking, it cannot be excluded that a foreign takeover would harm in some way the host economy through the cutting of jobs or R&D spending. However, such an effect cannot be excluded also when a domestic merger takes place. For example, Gugler and Yurtoglu (2004) identified negative effects on labour demand of M&A deals in Europe, but not in the US. They attribute such a finding to differences in labour market regulation: in Europe, mergers might be used to circumvent stricter labour regulation. Cassiman *et al* (2005) found that the impact of a merger on R&D output would mostly depend on how companies' technological capabilities are related. When technologies are substitutes, the effect of the deal on R&D output tends to be negative. But when technologies are complementary, the effect on R&D is positive. The literature suggests, in other words, that factors other than the ultimate owner's nationality are relevant to predict the effect of a merger on a national economy.

THE COST OF MEMBER STATES' INTERFERENCE

Sophisticated empirical papers based on companies' datasets from different European countries report inconsistent findings; results appear very much specific to the country, industry and time of observation. The absence of a clear-cut indication that foreign takeovers are more dangerous for the domestic economy suggests that member states should not retain any leeway to interfere in the process when the European Commission exerts its assessment power on cross-border mergers and the government's concern is essentially of an economic nature. That is because such interference would entail well-defined costs, in exchange for uncertain benefits.

The guiding principle followed by the Commission during its merger assessments is to protect competition and uphold the interests of the consumer. The Commission's



approach is consistent with that of all antitrust authorities in the developed world and is based on a solid economic principle: that preserving competition is the best way to maximise wealth in the economy. Here, economic literature provides for much more clear-cut insights. Correct enforcement of competition rules has positive effects on innovation by creating the incentives to deploy new and better products to beat competitors and gain fair rewards in terms of higher long-term profits (Motta, 2004). If the objective is to foster a healthy domestic industry, ensuring a level playing field with companies free to compete on an equal footing and no competitor shielded by protectionist measures is the best way to pursue it. Competition increases managers' incentives to perform: if they do not, they lose ground to competitors (Van Reenen, 2011). Competition also screens out inefficient companies: only the best survive if competition is not distorted (Disney *et al*, 2003).

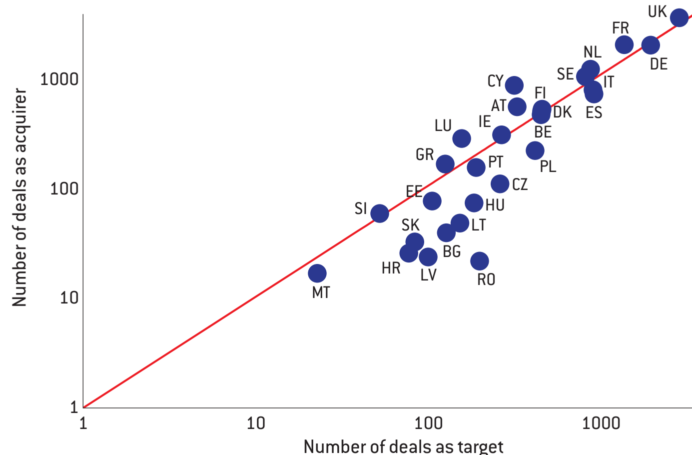
If the antitrust authority makes no mistake clearing a merger, competition does not decrease. A merger that does not reduce competition likely creates some value. Public institutions might intervene to alter how that value is distributed, but should not prevent that value from arising. A merger could create winners and losers: the enforcement of antitrust control ensures that winners win more than what losers lose. An efficient redistribution mechanism should therefore be conceived so that the value that is created is redistributed to those that lose out and that should be protected in the public interest. An efficient tax system can allow the transfer of some of the created value to redundant workers in the form of unemployment benefits, for example.

There are further compelling reasons why the cost of government intervention is high. A first consideration is strategic trade effects (see Brander and Spencer, 1985). The more leeway countries have the greater the risk that penalised companies' countries of origin will retaliate by implementing equally restrictive measures.

Figure 3 shows that there is a positive correlation between the number of deals in which a country is involved as target and the number of deals in which the same country is involved as an acquirer[6]. Even if the literature sometimes suggests that foreign companies relocate R&D activity to their home country after takeovers (Stiebale, 2013), retaliation by potential target countries would reduce the inward flow of R&D that would arise because of acquisition of foreign companies by domestic firms. Converging to a scenario in which all countries are less open to foreign acquisitions could imply lower net R&D outcomes for all economies. This 'protectionist spiral' would fundamentally undermine the existence of the single market.

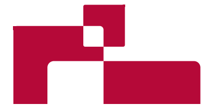
A second consideration is the risk of mistakes by public authorities. National policies might be captured by vested interests and this issue can become acute in an 'emotional' context, such as that surrounding the takeover of a national company by a foreign investor, particularly when jobs and innovation activities are at risk. Therefore more leeway in the application of merger rules might also mean, paradoxically, a higher risk of outcomes against the country's interest. Even an independent arbitrator might be subject to a domestic bias. Bhattacharya *et al* (2007), for example, identified a lower probability of adverse US court judgements for US domestic companies compared to foreign companies for a number of popular violations such as antitrust, breach of contract, employment-related, patent infringement and

Figure 3: Cross-border world M&A deals (log scale), 1990-2014



Source: Bruegel based on TR One database.

6. In Figure 3, countries above the 45° red line are world net acquirers (that is, their companies have more often bought a foreign company than have been bought by a foreigner), while countries below the red line are net targets. France has the highest active balance of deals (this is not apparent in Figure 3 because a log-scale has been used to make the graphical illustation neater).



product liability. It would also seem difficult to draw a line that would confine public intervention. If, for example, the objective of the government is to preserve jobs in the R&D sector, presumably there would be no need to use merger control to intervene and force a company to keep those jobs. Although arguably motivated by good intentions, the discussion around 'public interest' in merger control can drift towards state interventionism[7].

A third consideration is uncertainty. More leeway for member states would make it more difficult for foreign investors to predict the outcome of their acquisition plans. It could also give rise to multiple outcomes in Europe, since different countries could in principle impose different conditions on merging companies. This would reduce incentives to invest in Europe. Hence, if the aim is to enhance domestic production, attract new business to create jobs and import innovative activities, adding special scrutiny layers for foreign takeovers would likely achieve the opposite outcome. Julio and Yook (2013) investigated the relationship between cross-border capital flows and political uncertainty in host economies. They found that the capital flow from US companies towards their foreign affiliates drops by 12 percent during election years in host economies. Investment is lower when investors find it more difficult to anticipate future government policy; the potential for national measures that might limit business strategy makes that job even trickier.

THE NEED FOR A CLEARER INSTITUTIONAL FRAMEWORK

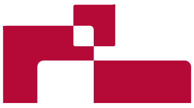
According to Article 21(4) of the EUMR, public security, plurality of media and prudential rules are considered by default legitimate interests that a national government can protect through direct intervention. But *"any other public interest [...] shall be recognised by the Commission [only] after an assessment of its compatibility with the general principles and other provision of Community law"*. However, there is currently no clarity about how such an assessment would be made. There is no public set of criteria systematically used by the Commission to assess the legitimacy of a claimed public interest in merger control. This is a fertile territory for inter-institutional conflict. Governments might sometimes attempt to circumvent the EUMR by widening the scope of the definition of 'strategic sectors', thereby making it easier for government to justify intervention. But currently the Commission intervenes only when a government takes a formal decision specific to the merger case. It would not intervene to challenge a general law or decree. This is the case, for example, with the decree adopted by the French government on 15 May 2014 in an attempt to impose conditions on General Electric's takeover of Alstom. The decree was labelled the 'French nuclear weapon against foreign takeovers'[8], but the European Commission did not start any formal proceeding against it because it was not actually enforced. In fact, governments might simply adopt laws that could empower the government to impose conditions potentially falling foul of Article 21(4) EUMR because most of the time they will not implement them: companies might be willing to negotiate and accept conditions because they cannot wait to see the end of a judicial process through which the Commission challenges a government before the European courts[9]. This also explains why Article 21(4) EUMR infringement cases are rare (no more than eight in the last 25 years). Moreover, even if the Commission intervenes, there is a high degree of uncertainty about the final outcome of court proceedings.

The Commission should therefore play a more proactive role to reduce uncertainty in significant cross border merger deals and to effectively constrain governments' ability to influence the process when this can be potentially harmful. The Commission should draft and propose *ad-hoc* guidelines for the assessment of Article 21 EUMR cases. It should specify the criteria under which government intervention would be allowed in exceptional circumstances. It should clearly define the boundaries of public security, plurality of the media and prudential rules and specify the conditions for identifying other legitimate strategic interests that a government would be allowed to protect. It should be emphasised that economic concerns can never be a legitimate reason for intervention. Such guidelines should be drafted through an open process; contributions from stakeholders should be sought in the usual fashion in order to be certain that the Commission is given the tools needed for the

7. See, for example, Martin Wolf (2014) 'AstraZeneca is more than investors' call', *Financial Times*, 8 May. Wolf asks *"who ought to control the fate of companies. Should this be up to shareholders alone or do other interests matter?"* in the wake of the Pfizer/AstraZeneca attempted deal.

8. Hugh Carnegy, Michael Stothard and Elizabeth Rigby (2014) 'French 'nuclear weapon' against foreign takeovers sparks UK blast', *Financial Times*, 15 May.

9. A good example is E.ON/Endesa – see footnote 2.



proper assessment of potential national strategic issues. Guidelines would have a twofold purpose: they would help governments to anticipate the Commission's approach and converge on consistent approaches in Europe; and they would reduce uncertainty for foreign investors, hence making potentially welfare-enhancing deals more likely.

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