

The Euro and European M&A

Robert F. Bruner
Distinguished Professor of Business Administration
Darden Graduate School of Business
University of Virginia

Viewed from America, one of the most interesting laboratories for M&A today is the new European Monetary Union. There, potent forces may mix to produce significant changes in M&A activity, and to redefine standard practices of business combination. Consider, for instance, three possible developments:

1. Europe will experience an M&A wave as capital markets and product markets adjust to the new common currency.
2. Cross-border M&A will be the fastest-growing segment of activity within this wave.
3. M&A practices will grow more "American" reflecting a gradual shift in power toward equity investors, at the expense of other stakeholders.

It is easy to discount such outlooks. But if the history of finance and M&A are any guide, these speculations contain more than a grain of reality. More importantly, they should stimulate senior executives to consider the resulting threats and opportunities in M&A. The point of speculation is to alert and educate the decision-maker. Therefore, let us turn to weigh each speculation in more detail.

Euro-driven Product Market Changes

The Euro will be associated with significant changes in European product markets and capital markets. These changes, in turn, will stimulate increased M&A activity.

Most observers expect product market competition to increase thanks to greater transparency about product and factor prices across the EMU. Once product prices are denominated in the same units across Europe, the more efficient producers will be motivated to enter new markets, and compete on price. In this context, M&A will be used as both a defensive and an offensive tactic.

The history of M&A in America offers abundant evidence that waves are significantly driven by product market changes. The first great wave of consolidation in the late nineteenth century was significantly driven by competitive pressures to exploit operating efficiencies of horizontal combination. The second wave, in the 1920s, exploited economies of vertical combination, also driven by competitive pressures. The third wave, in the 1960s, exploited benefits of new developments in management, reporting, and control, and resulted in the creation of large conglomerate firms. The wave of the 1980s arguably was a response to an episode of high inflation in developed economies, and to the liberalization of trade. And the wave of strategic buying in the 1990s is motivated significantly by product market changes stimulated by deregulation, new technology, and globalization. In short, competitive developments in product markets are highly stimulative to M&A activity. Thus, Euro-induced changes in competition reasonably may be expected to drive a surge in M&A activity.

In light of the historical experience in America, the burden of proof should be on the skeptics to explain why the Euro will not affect M&A activity. In the interest of balance, let me offer one counterargument: it is not the Euro, but the general trend of economic integration within Europe, and between Europe and other regions of the world, that will drive a wave of consolidation. Thus, the skeptics would have it that

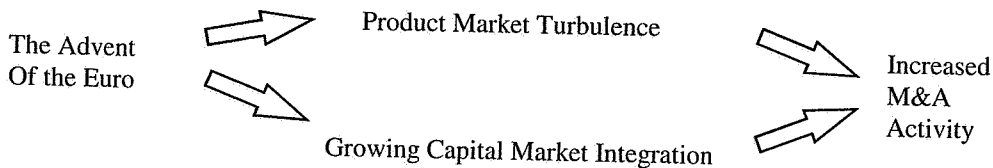
the Euro is merely a detail, a side-show, in comparison to larger forces at work, such as deregulation, tax harmonization, trade liberalization, and demographic movements—all these are manifestations of increasing integration. Twenty years from now it will be difficult, if not impossible to separate the impact of the Euro from other aspects of integration in their impact on business consolidation. As the saying goes, a successful forecast has many fathers. But my reply to this objection is that it proves the broader point: product market turbulence drives M&A activity.

Euro-driven Capital Market Changes

The advent of the Euro will stimulate the integration of the national capital markets. This will result in a deepening of pools of available capital, and a more rapid dispersion of financial innovations. Europe will make the transition from a fixed income investment culture to an equity culture. Appetites for equity securities will broaden to include quasi-equities, and equities of foreign firms (from both developed countries and emerging countries.) We will see the emergence of EDRs (European Depositary Receipts). More pools of venture capital and private equity investors will arise to finance risky firms. Equity market valuations (represented by their multiples) will converge across Europe. The debt markets will grow in sophistication: investors' appetites for longer-maturity corporate debt will grow, as will their appetite for more risky corporate debt. This will imply a disintermediation in the financing of firms: banks will lose their key role as the source of financing to securities markets. Accordingly, we will see more deals among financial institutions, as excess capacity gets squeezed out.

The chief result of these capital market changes is that M&A financing will become cheaper, easier to obtain, and available in forms that are tailored more readily to the needs of M&A participants. We know that M&A activity is very significantly influenced by the level of capital costs, and the availability of financing.

Putting together these arguments about product markets and capital markets suggests this train of causality:



More Cross-Border Deals

The second speculation is that the advent of the Euro will be associated with an increasing proportion of cross-border M&A transactions. Professor Leo Sleuwaegen has determined that over the period 1994-96, about 60 percent of all mergers and acquisitions in the EU involved firms located in the same member state. Three factors suggest that with the advent of the Euro, this percentage will decline.

First, the Euro is a cross-border phenomenon, a manifestation of the larger European integration. The product market turbulence described above springs from the cross-border transparency of prices, and subsequent entry of foreign firms into domestic markets. No doubt, this turbulence will stimulate the consolidation of domestic competitors. But the same turbulence will make it attractive to create pan-EMU combinations.

Second, the firms that survive the product market turbulence will become more potent and attractive M&A partners. European firms will buy companies outside of the EMU, as acquisition financing grows. Foreign firms will buy into Europe to gain competitive footholds.

Third, history shows that as regional economic integration rises, so does the volume of cross-border deals among states within the region, and between the region and elsewhere. The experience of NAFTA, particularly with reference to Mexico, and of the Mercosur group of nations in South America, illustrate this impact of integration on M&A activity.

“Americanization” of M&A Practices

The increasing capital market integration associated with the Euro is likely to elevate the importance of the sophisticated equity investor in the mind-set of European corporate managers—probably at the expense of other stakeholders. A prime example of this shift is DaimlerChrysler, whose senior managers had been moving toward a stockholder (rather than stakeholder) focus well before the merger with Chrysler. A shift such as this will be caused by rising product market competition, the advent of the equity investing culture mentioned above, and the rising attractiveness of European equities to American investors. As the equity orientation grows, acceptable M&A practice is bound to change.

First, overpayment will be penalized; price will become the first object of attention. Equity investors of the buying firm suffer the consequences of overpayment; as those investors gain a greater share of management’s mind, managers may become more price conscious.

Second, the volume of unsolicited acquisition attempts may rise. The product market scenario outlined above may place special importance on the advantage of the “first mover.” To enter new markets rapidly, decisively, and first, may dictate tactics that are at their core, impatient. The unsolicited acquisition attempt is risky, but may be justified in managers’ minds by the circumstances. Olivetti’s hostile bid for the leading Italian telecommunications firm is an example of an American-style bid offered in Europe. We have seen other examples of these tactics on the European continent in recent years. The unsolicited bid is no longer a feature only of the Anglo-American sphere.

Third, deal structures may reflect greater use of innovative terms including derivative securities, bridge loans, and “junk” debt. The growing sophistication and integration in the capital markets will make this possible.

Assumptions on which these Speculations Depend

A forecast is only as good as its assumptions. There are at least three “bets” underlying the speculations above. The first is a stable political climate and continuing trend of deregulation. Political stability is necessary to free the European Central Bank, and to continue the cycle of deregulation that underpins the M&A cycle. Some of the recent sparring between senior continental politicians and the central bank suggest that monetary policy that is perfectly independent of political considerations has yet to be accepted. The second “bet” is stable or buoyant economic growth. Germany’s GDP contracted in the fourth quarter of 1998, a worrisome result not only for the economic outlook, but also for the political pressures that it might create. Acquisitions are inherently acts of optimism. Deteriorating economic conditions would likely impair that optimism, and the resulting volume of deals. The third “bet” is for symmetric economic growth. A pan-European currency will be costly to stronger countries if there are asymmetric economic shocks within the region. Economic pain will be shared in the Europe of the Euro,

fueling political pressures, and perhaps stimulating populist re-regulation of business. America witnessed huge internal fiscal and labor transfers resulting from various regional shocks in the 1980s and 1990s. Another example is the unification of Germany, which resulted in huge fiscal transfers from west to east, along with high unemployment in the east. In both instances, the political and economic systems absorbed the asymmetric shocks but not without the active murmuring against symptoms of turbulence such as M&A activity.

Conclusion

Speculating about future activity in M&A is not only entertaining; it is also informative. Executives, like chess players, can use speculations about the future lay of the gameboard to plan winning moves. In both M&A and chess, ignorance and passivity are to be avoided.