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Corporate restructuring and M&A activity

José Manuel Campa*

The market for corporate restructuring has shown a fast rebound over the last two years. We are observing corporations engaging in a new wave of M&A transactions at a global scale not seen since the peak in the late part of the previous decade. This increase in transactions reflects partly the recovery in world financial markets but is also due to the changes in technology and globalization in the world economy.

The European Union has been a major player in this new cycle of economic reorganization. In the last two months we have seen unsolicited purchase offers for Spain's largest utility, the world's largest airport operator based in the UK and the London Stock Exchange. Despite this recent spur in cross-border M&A in Europe, most of the transactions that are actually taking place occur among domestic competitors. Integration and corporate restructuring across European borders remain difficult and unlikely to succeed.

This paper provides a framework for understanding the underlying reasons for this spur in corporate restructuring activity. The first section reviews the major trends of technological change and globalization that are re-designing the boundaries of the firm. The next section reviews the trend in M&A activity in the world, with a particular emphasis on European evidence, and the underlying arguments for its development. The last section provides a case study of the European retail banking industry to highlight the barriers that deter further integration and restructuring within the European corporate sector.

Firm structure – size and ownership

Technological innovations in the last decade and economic policies pursued by many countries towards increased globalization have led firms to engage in major restructuring activities of their operations. Most of the discussion, especially among policy circles in Western Europe, has focused on the shifting of production facilities overseas by firms producing in the large European countries. However, the deeper issue at the core of this debate concerns the optimal size of the firm.

Optimal firm size has been a major issue

Any firm must choose the set of activities in the value-added chain that it would like to do within the firm and those activities it would like to buy from third parties. For the subset of activities the firm decides to produce, the location of its production facilities is also an issue (see Chart below). The conditions under which a firm should perform operations within the firm in its existing operations, relocate its production facilities abroad (offshoring) or subcontract them to an alternative producer (outsourcing) are at the core of the current debate on the implications of globalization.

These organizational alternatives have been exploited to a different degree by different firms implying a large degree of corporate restructuring. In the last decade, some additional drivers for this restructuring of the size of firms have become more predominant. They can be separated into two broad categories: technological progress and economic liberalization. Technological advance has been at the core of production relocation for centuries. Traditional neoclassical economic theories based location and trade patterns on the idea of comparative advantage. Comparative advantage focuses on the fact that countries will specialize in the production of those goods for which their relative endowments of labor, natural inputs and relative productivities makes them more attractive. Under this view of the world, goods are tradable in world markets, while factors of production (with the exception of capital and some primary commodities) are not. Production and trade would lead to the eventual convergence of relative world prices to the differentials in productivity across these different locations.

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The structure of production inside and outside the firm

		Ownership of activities	
		Internal to the firm	External to the firm
Location of activities	Home	*Domestic in-house production* (firm produces its products domestically without any outside contracts)	*Domestic outsourcing* (firm uses inputs supplied by another domestically-based company)
	Overseas	*Offshoring* (firm uses inputs supplied by its foreign-based affiliates)	*International outsourcing* (firm uses inputs suplied by an unaffiliated foreign-based company)

Source: European Commission, The EU Economy 2005 Review, ECFIN REP 55229.

Two major technological shifts have caused a revision of this paradigm. First, technological developments have induced firms to exploit to a larger extent the benefits of efficient size and economies of scale in production. Economies of scale can be achieved by having intangible assets with a public good component that can be exploited at no additional cost over a larger size. To the extent that the diffusion of this technological know-how is more efficiently performed within the firm, this technology-based competitive advantage determines the bounds of the activities performed within the firm and the size of the multinational enterprise (Caves 1996). In this world with economies of scale volume is key. Firms are no longer attracted by locations with cheap inputs that are perceived to be exogenous. Rather, other inputs such as specialized labor, specialized intermediate inputs or the presence of complementary technologies, become important.

Technological change has been one driver of company restructuring

A second major technological shift has been the development of information technologies. These technologies have made it possible to decrease communication costs drastically across the world. They have also increased the range of goods and services that are tradable in world markets. The traditional economic division of products between goods and services was determined by the characteristics of each product in terms of tradability. To be a good, its production and consumption did not have to take place at the same moment in time. A service, in contrast, required that production and consumption happened simultaneously. Therefore, goods were essentially tradable, whereas services were non-tradable. This implied that the production of services was isolated from international competition in world markets beyond foreign direct investment. Modern information and communication technologies, however, have made a large array of service products tradable in world markets. Call centers, reservation centers, data-processing rooms, software consulting and education services are just a small sample of the range of services that recent technological progress has made tradable in world markets. Essentially, anything that can be digitalized in computer code has become a tradable product. This revolution implies changes in the value chain of firms and has caused them to redefine their production strategy, size and the location of their production facilities.

The existing evidence for the European Union suggests that manufacturing relocation and offshoring has had a deep impact on the structure of production. The prevalence of offshoring, both internal and external to the firm, has led to a decrease in the ratio of domestic value added per unit of output – the so called production depth – over the last decade. For instance, the share of imported intermediate inputs in German exports, including the imports of exported merchandise, increased from about 30 percent in 1995 to 38.8 percent in 2002 (Cesifo, 2005). It has also led to a strong linkage between exports and imports of the country. An additional unit of exports in Germany in 2002 implied an increase of 0.55 in imported intermediate inputs into the country.

The evidence on service outsourcing is very limited. The existing evidence indicates that its prevalence is still very small although growing fast. The *Ministère de l'Economie, des Finances et de l'Industrie* in France shows that in 2003/04 the international outsourcing of computing services represented only 2 percent to 3 percent of the country's total computing service industry (European Commission 2005). The UK had a similarly low ratio, at 1.2 percent (Amiti et al. 2005). Nonetheless, Amiti et al. report that the outsourcing intensity ratio of service inputs has increased from 3.5 percent (0.4 percent) in 1992 to 5.5 percent (0.8 percent) in 2001 in the UK (U.S.).

Recent trends in European M&A activity

Overall M&A activity in Europe has increased significantly over the last two years. According to Thomson Financial, in the first half of 2005 European M&A totalled US$403 billion, compared to US$362 billion a year earlier, and it had reached volumes similar to its peak in 2000. Part of this trend has been caused by an overall increase in the volume of M&A activity in the world which had risen from US$1200 billion in 2002 to US$1260 billion in only the first six months of 2005. This increase was also perceptible in the number of transactions that went from just over 9,700 in 1997 to a peak of 16,750 firms in 2000 and to over 15,000 transactions in just the first half of 2005. This section looks at why this volume of activity is happening now and where all this corporate restructuring is taking us.

Mergers and acquisitions are well known to undergo waves of activity around the business cycle and stock market booms. In this context, the current boom in M&A transactions in Europe is not specific to the region but part of a worldwide trend. In fact, the share of European M&As in world transactions was 34 percent in the first half of 2005 and thus very similar to its value in the mid-1990s. Some explanations have been put forward to explain this correlation between M&A activity and business and financial cycles. Shleifer and Vishny (2003) and Rhodes-Kropf and Viswanathan (2004) report models of financial market inefficiency in which relative valuations between acquirers and bidders drive merger waves. In both cases, managers in the firms take advantage of the inefficient pricing in financial markets to engage in M&A activity. A second line of explanation relies on the behaviour of the economic cycle and technological shocks. Jovanovich and Rousseau (2004) show that technological shocks, to the extent that they do not happen homogeneously to all players in an industry, can lead to capital reallocation among the players in an industry. (Lambrecht 2004) also shows that the increased benefits of size in industries, in which economies of scale matter, drive mergers around cyclical patterns since firms want to be larger when they expect demand to be also large.

A second argument for an increase in mergers in Europe has been the creation of the Single Market in 1993 and more recently the introduction of the euro. The euro has generated a very large and deep financial market in which firms have easier and cheaper access to funds for financing their growth. At the same time, the creation of this financial market has decreased the costs of engaging in cross-border transactions and fostered integration both in the financial and goods markets.

Despite this internationalization of the euro area, the vast majority of merger activity continues to take place within individual European countries. The European Commission reported that the proportion of domestic M&A transactions, i.e. M&As involving firms from the same EU member country, relative to total M&A transactions involving a EU corporation has remained constant in the last decade at slightly over 50 percent (57 percent in 2004 vs. 58 percent in 1995) (European Commission, 2005). One of the main characteristics of M&A in 2005 is that we have observed large cross-border European transactions in a more consistent pattern. The purchases of O2 by Telefonica and of the HVB Group by Unicredito were two of the largest reported transactions last year. Both of them involved large cross-border acquisitions in regulated markets that remind us of the previous cycle that peaked in 1999–2000 with the purchase of Mannesman by Vodafone. Despite these examples, cross-border M&As in Europe continue to be the exception rather than the rule.

Despite some big cases, cross-border M&A in Europe remain the exception

It is difficult to know exactly what the sources of frictions among firms are that deter them from engaging in cross-border EU transactions. Technological reasons are clearly part of the explanation. But also lacking possibilities of exploiting economies of scale, differences in taxation, regulatory and supervisory agencies, as well as the negative reaction of stakeholders all play a role in determining this perception. The size and relative importance of these barriers are likely to differ by industry and no general principle may apply to all industries. To get a better sense of the relative importance of these impediments to cross-border consolidation, we focus in the next section on the case study of the European financial industry.

M&A activity in the European financial industry

The financial industry followed a similar pattern of M&A activity as overall European industry. M&As were very intense during the late 1990s and considerably weaker from 2001 to 2003 with a recovery in the last two years. However, European cross-border M&As in the financial industry are much less com-

mon than in other industries. From 1999 to 2004 the share of cross-border transactions in the financial industry in total M&As in the European Union has remained at 20 percent. In other sectors, this share has been consistently large, reaching a peak of over 60 percent in 2000 (European Commission 2005). It is worth mentioning that international M&As in the banking industry are carried out more often with banks from outside the euro-zone than with banks from different euro-area countries (Hartmann et al. 2004). In 2001, cross-border euro-area M&As accounted for only 11 percent of all transactions, while cross-border transactions beyond the euro area were almost four times larger, accounting for 42 percent of transactions. Despite the large transactions that we have seen in the last two years, mainly through the purchase of Abbey by Santander and the purchase of HVB in Germany by Unicredito, the battle that arose among foreign participants, regulators and the domestic Italian banking sector following the announcement of bids for Italian banks by BBVA and ABN Amro exemplifies some of the barriers that this integration may confront.

European financial integration is already quite advanced – except for retail banking

The trend in M&As has also implied an important qualitative change in terms of industry structure. In the late 1990s, invested volumes among domestic competitors increased as these transactions more aggressively pursued market access and an enhancement of the competitive position of the firms involved. This resulted in substantial increases in market concentration at the national level during this period (European Central Bank 2005). From 1997 to 2004, the number of banks operating in the EU banking sector declined by 26 percent. The average share of total banking assets accounted for by the five largest institutions (the C5 concentration ratio) increased in all major national markets of the euro area over the period 1997-2004. In Spain, the C5 ratio increased by 12 percentage points (from 32 percent to 44 percent); in France and Germany, by 5 pp. (from 40 percent to 45 percent and from 17 percent to 22 percent respectively). National differences in concentration are still large, with Germany having one of the less concentrated banking sectors while smaller countries like the Netherlands, Finland and Belgium have five-firm concentration ratios above 80 percent. The unweighted average of the C5 ratios for the 12 EU-15 member countries increased from 46 percent in 1997 to 53 percent in 2004. This increase in concentration ratios may be cause for concern if it reflects increased market power, particularly for some EU countries in which concentration ratios have risen to very large numbers. Nevertheless, looking at the euro area as a whole, concentration is markedly lower. Bikker and Wesseling (2003) report that the C5 concentration ratio for the euro area, i.e. the market share of the largest five euro area banks, increased only by 4 pp., from 12 percent in 1996 to 16 percent in 2001.

There are a number of reasons for this lack of cross-border M&A in the European financial industry. In part, the integration of the European financial services industry has developed beyond M&A transactions.[1] This integration is reflected in a quick convergence of prices and large cross-border trading in certain markets. In the money market, actual transaction prices for overnight rates in the euro interbank market have converged to within 2 basis points; beyond this point arbitrage is no longer profitable. European stock markets have also been largely integrated. In wholesale banking, prices have also converged very fast within the euro-area countries. International flows within the European banking sector have also significantly increased during this period. Pérez et al. (2005) report an increase in the proportion of the total amount of foreign claims received(sent) from(to) euro area countries from 17.1 percent of total banking assets in euro-area countries in 1999 to 22.2 percent in 2002. This number is higher for smaller countries indicating a higher degree of cross-border flow, but still low in absolute terms (see Campa and Hernando 2006).

Nevertheless, integration is still lacking in retail banking markets. In this respect, a recent survey by the European Commission states that there are intrinsic characteristics of the traditional banking business that constrain the cross-border expansion of commercial banking. Among these differences, the lack of overlapping fixed costs in international integration and the diversity of business practices appear to be the most important barriers to integration within the industry (European Commission 2005). This lack of integration in the retail banking segment is reflected in the large differences in the breakdown of net income from the different national retail banking industries (J.P. Morgan 2004). This heterogeneity in the sources of value-added by product in the different national banking markets reflects underlying differences in the functioning of these markets in the European Union and they imply an

[1] See Baele et al. (2004) for a review of alternative measures to quantify the degree of financial integration in the euro area.

important barrier to developing financial integration within the Union.

The second set of barriers identified in the survey was related to attitudes of the population and the stakeholders. In particular, the negative reactions by employees and customers to a possible acquisition by a foreign entity were mentioned as an important deterrent for engaging in such transactions. Regulatory barriers also played a role. In particular, the existence of more than one supervisory agency (from the home and host countries) and the differences in supervision that these two entities may impose was the most commonly mentioned barrier to engaging in an international transaction. In contrast, political interference and fiscal issues played a much smaller role.

Concluding remarks

The optimal size of the firm has been a major issue in the economic literature for centuries. Technological innovations and economic policies towards globalization have affected the set of activities that firms are choosing to perform within and outside their organizations. These trends have recently caused a large shift in corporate restructuring and M&As.

European economic integration is immersed in this process of corporate restructuring. Despite large improvements in the integration of markets across Europe, most M&A transactions still involve the integration of two firms from the same country. Cross-border transactions in Europe are still the exception and this lack of activity is signalling, to a large degree, difficulties in the ability of firms to exploit the benefits from technological innovation and integration in a Europe-wide strategy, given the large differences that still remain in industry structure across member countries.

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