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THE MARKET FOR MERGERS AND THE BOUNDARIES OF THE FIRM

José Manuel Campa*

Abstract

Technological innovations and the economic policies adopted in response to globalization have affected firms' decision as to which activities to perform themselves and which to outsource. In recent years, these trends have caused a large shift in corporate restructuring and M&As. European economic integration is immersed in this process of corporate restructuring. Despite big improvements in European market integration, most M&A deals in Europe still involve mergers between firms from the same country; cross-border transactions are still the exception. This lack of activity largely signals the difficulties that firms adopting a Europe-wide strategy encounter when it comes to exploiting the benefits of technological innovation and integration, due to persistent significant differences in industry structure across member countries

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THE MARKET FOR MERGERS AND THE BOUNDARIES OF THE FIRM[1]

The market for corporate restructuring has rebounded quickly in the last two years. Corporations are currently engaged in a wave of M&A transactions on a global scale not seen since the peak in the late 1990s. This increase in transactions partly reflects the recovery in world financial markets but also is due to changes in technology and the globalization of 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 bids for Spain's largest utility, the world's largest airport operator (based in the UK), and the London Stock Exchange. Despite this recent surge in cross-border M & A in Europe, most mergers are among domestic competitors. Integration and corporate restructuring across European borders remains difficult and unlikely to succeed.

This paper provides a framework for understanding the underlying reasons for this surge in corporate restructuring activity. The first section reviews the major trends of technological change and globalization that are redrawing the boundaries of the firm. The next section reviews the trends in M&A activity worldwide, with special emphasis on the European evidence and the underlying reasons 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 during the last decade and the economic policies adopted by many countries in the face of increased globalization have led firms to engage in major restructuring of their operations. Most of this 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, at the core of this debate is a deeper issue regarding what is the optimal size of the firm.

Every firm must chose the set of activities in the value added chain that it will carry out itself and which it will subcontract to third parties. For the subset of activities the firm decides to

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carry out itself, the location of its production facilities is also an issue (see Figure 1). Under what conditions should a firm perform operations itself, relocate its production facilities abroad (offshoring) or subcontract them to an alternative producer (outsourcing)? This question is at the core of the current debate on the implications of globalization.

Different firms have exploited these three organizational alternatives to differing degrees, leading to corporate restructuring. In the last decade, some additional drivers for this restructuring of firms have become more predominant. They can be grouped in two broad categories: technological progress and economic liberalization.

Technological advance has been at the core of production relocation for centuries. Traditional neo-classical economic theories based location and trade patterns on the idea of comparative advantage. Comparative advantage focused on the fact that countries will specialize in the production of the goods for which their endowment of labor and natural inputs and their relative productivity make them most attractive. According to this view of the world, goods are tradable in world markets, while inputs of production (with the exception of capital and some primary commodities) are not. Production and trade will lead to the eventual convergence of relative world prices to the differentials in productivity across these different locations.

Two major technological shifts have led to a revision of this paradigm. First, technological developments have encouraged firms to exploit the benefits of efficient size and economies of scale in their 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 not longer attracted by locations with cheap inputs that are perceived to be exogenous. In contrast, other inputs such as specialized labor, specialized intermediate inputs or the presence of complementary technologies become important.

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 tradability of each product. A "good" was a product that did not have to be produced and consumed in the same place and at the same time; with a "service", in contrast, production and consumption were simultaneous. Therefore, goods were essentially tradable products, while services were nontradable. This implied that the production of services was isolated from international competition in world markets, beyond foreign direct investment. Modern information and communication technologies have made a broad 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 has brought about changes in firms' value chain and has led them to redefine their production strategy, their size and the location of their production facilities.

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 also led to a strong link between exports and imports within a country. In Germany in 2002, for example, one additional unit of exports 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 but growing fast. The French Ministry of the Economy, Finance and Industry reports that, in France in 2003/04, international outsourcing of computing services accounted for only 2 to 3 percent of total computing services (European Commission 2005). The UK had a similarly low ratio of 1.2 percent (Amiti et al. 2005). Nonetheless, Amiti et al. (2005) report that the outsourcing intensity ratio of service inputs has increased from 3.5 percent (0.4%) in 1992 to 5.5 percent (0.8%) 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 totaled US$403 billion, compared to US$362 billion a year earlier, and had reached volumes similar to its peak in 2000. Part of this trend is due to an overall increase in the volume of M&A activity worldwide, which rose from US$1200 billion in 2002 to US$1260 billion in only the first six months of 2005. The increase was also apparent in the number of transactions, which went from just over 9700 in 1997 to a peak of 16,750 firms in 2000, compared to 15,000 transactions in the first six months of 2005 alone. This section looks at why this volume of activity is happening now and where all this corporate restructuring is taking us.

Merger and acquisition activity is known to be closely related to the business cycle and stock market booms. Thus, 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, little different from the mid-1990s. Some theories have been put forward to explain this correlation between M&A activity and the 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 firms take advantage of inefficient pricing in financial markets to engage in M&A activity, driving the merger waves. A second line of explanation focuses on the behavior of the economic cycle and technological shocks. Jovanovich and Russeau (2004) show that technological shocks, to the extent that they do not affect all players in an industry equally, can lead to capital reallocation among players in an industry. Lambrech (2004) also shows that the increased benefits of size in industries in which economics of scale matter drive mergers around cyclical patterns, as firms want to be larger when they expect demand also to be large.

A second argument for an increase in mergers in Europe has been the creation of the Euro and integration among European borders, which has been taking place since the creation of the Single Market in 1993 and most particularly since 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 reduced the costs of engaging in cross-border transactions, fostering integration in both the financial and the goods markets.

Despite the internationalization of the euro area, the vast majority of merger activity continues to take place within European countries. The Commission reported (European Commission 2005) that the proportion of domestic M&A activity, 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 over the last decade at slightly over 50% (57% in 2004 vs. 58% in 1995). One of the main characteristics of 2005 was a more consistent pattern of large cross-border European transactions. The purchases of O2 by Telefónica and of HVB Group by Unicrédito were two of the largest reported transactions last year. Both involved large cross-border acquisitions in regulated markets, reminding us of the previous cycle, which 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.

It is difficult to know exactly what are the sources of frictions among firms that deter them from engaging in cross-border EU transactions. Technological reasons are clearly part of the explanation. But lack of opportunity to exploit economies of scale, differences in taxation, regulatory and supervisory agencies, and negative reactions by stakeholders all play a role in shaping this perception. The size and relative importance of these barriers are likely to differ by industry and most likely no general principle applies 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 a case study of the European financial industry.

M&A activity in the European financial industry

The pattern of M&A activity in the financial industry is similar to that of European industry as a whole. M&As were very intense during the late nineties and considerably weaker from 2001 to 2003, with a recovery in the last two years. However, cross-border M&As in Europe are much less common in finance than in other industries. From 1999 to 2004 the share of cross-border transactions in the financial industry relative to total M&As in the European union remained at 20%. In other sectors, this share was consistently large, reaching a peak of over 60% 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 among banks from different euro area countries (Hartmann et al. 2004). In 2001, cross-border euro area M&As accounted for only 11% of all transactions, while cross-border transactions beyond the euro area were almost four times more frequent, accounting for 42% of transactions. Despite the large transactions that we have seen in the last two years (mainly the purchase of Abbey by Santander and Unicrédito's purchase of HVB in Germany), the battle that the announcement of bids for Italian banks by BBVA and ABN Amro sparked among foreign participants, regulators and the domestic Italian banking sector illustrates some of the barriers such integration has to face.

This trend in M&As has brought with it an important qualitative change in industry structure. In the late 1990s, invested volumes among domestic competitors increased, as these transactions were more aggressive in pursuing market access and enhancing 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 there was a 26% reduction in the number of banks operating in the EU. The average share of total banking assets the five largest institutions (the C5 concentration ratio) increased in all major national markets in the euro area over the period 1997-2004. In Spain the C5 ratio increased by 12 percentage points (from 32% to 44%); in France and Germany, by 5 pp. (from 40% to 45% and from 17% to 22%, respectively). National differences in concentration are still large, with Germany having one of the least concentrated banking sectors, while smaller countries like the Netherlands, Finland and Belgium have 5-firm concentration ratios above 80%. The unweighted average of the C5 ratios for the 12 EU-15 member countries increased from 46% in 1997 to 53% in 2004. This increase in concentration ratios may be a cause for concern if it reflects increased market power, particularly for EU countries in which concentration ratios have risen to very high levels. 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 by only 4 pp., from 12% in 1996 to 16% in 2001.

There are a number of reasons for this lack of cross-border M&A activity in the European financial industry. In part, the integration of the European financial services industry has developed beyond M&A transactions[2]. This integration can be clearly seen in the quick convergence of prices and heavy 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 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 total amount of foreign claims received(sent) from(to) euro area countries from 17.1% of the total of banking assets in euro area countries in 1999 to 22.2% 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. Of these differences, the lack of overlapping of 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 in the different national retail banking industries (J.P. Morgan 2004). This heterogeneity in the sources of value by product in the different national banking markets reflect underlying differences in the way these markets function in the European Union, and represent a significant barrier to EU financial integration.

The second set of barriers identified in the survey have to do with attitudes among the general population and stakeholders. In particular, possible negative reactions by employees and customers to acquisition by a foreign bank were cited as a major deterrent to M&A transactions. Regulatory barriers also played a role. In particular, being subject to more than one supervisory agency (home and host country supervisor) and possible differences in supervision

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

was the most commonly mentioned barrier to international mergers. In contrast, political interference and taxation 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 firms' choice of which activities to perform themselves and which to outsource. These trends have recently led to 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 deals still involve the merger of two firms from the same country. Cross-border transactions in Europe remain the exception. This lack of activity signals the difficulty that firms are having in exploiting the benefits of technological innovations and integration in a Europe-wide strategy, because of the persistent significant differences in industry structure across member countries.

Figure 1

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 supplied by an unaffiliated foreign-based company)

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

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