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"Hollowing Out": Myth and Reality
Corporate Takeovers in an Age of Transformation

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Part 1: Research Approach

We Asked Two Questions

1. **What is happening?**

- Do takeovers have an *impact* on companies that are taken over and, if so, are the impacts positive or negative?
- Is there any *difference* in the impact of foreign takeovers of Canadian companies vs Canadian takeovers of Canadian companies or foreign companies?

We Asked Two Questions

2. **Why the concern?**

   What are the economic and non-economic reasons why people are concerned about corporate takeovers and "hollowing out" effects?

Methodology

- **M&A literature** – domestic and international studies of M&A, impacts.
- **Media coverage** – extent and nature of media coverage.
- **Theories** – economic and non-economic theories and ideas that underpin M&A—and arguments about “hollowing out”.

Methodology

- **Macro-data analysis:**
  - Overall FDI and M&A data
  - Largest 200 companies in 1990 (by revenue)
  - Largest deals (by $ value)1994 – 2007 – '540 sample'
- **Micro-data analysis: Case studies**
  - Foreign takeovers of Canadian firms – 15
  - Canadian takeovers of Canadian firms – 7
  - Canadian takeovers of foreign firms - 8

Part 2: What is Happening?

Long-Term Trends

- Corporate takeovers, *long-term*, show a *favourable balance* for Canada: higher outflow than inflow of M&A (and FDI).
- No *long-term* trend toward greater foreign ownership of the economy.
- Foreign control *stable* at about 30 per cent – significantly below peak levels of the 1970s.

Corporate Transformation

- Corporate transformation is the norm—companies are constantly changing.
- *Takeovers* are part of bigger phenomenon of *corporate transformation* in Canada—including *aggregation* in some sectors.
- Only 71 of top 200 Canadian companies of 1990 (by revenue) are still on Top 200 list with same name and shareholder structure.

Corporate Transformation

- M&A is one type of transformation
- Canadian M&A of Canadian companies is a *more frequent* means of transformation than foreign M&A.
- Biggest changes in finance and insurance – 36 companies disappeared – heavy *aggregation* occurred in this ‘protected’ sector, by Canadian firms.

M&A Over $500 million (constant 2007 $), Greater Than 50 Per Cent Stake, 1994-2007

Category	Deals 1994 to 2004	Deals 2005 to Oct. 2007	Deals Total	Ave per Deal Constant 2007 $ billions
Foreign acquires Canadian	92	62	154	2.9
Canadian acquires foreign	**133**	53	186	2.1
Canadian acquires Canadian	128	**72**	**200**	1.9
Total	353	187	540	

Motives for Takeovers

- Corporate takeovers are driven by firm-level business needs, and market conditions, not national interests.
- Business interests drive the act of takeover *not* notions of being ‘corporate champions’.

Effects of Takeovers

- Similarly, the effects of corporate takeovers are largely determined by the *business decisions* taken by the acquirer.
- These decisions spring from acquirer's business strategy and tactics, plus industry factors (demand & supply conditions, regulations, etc.) that influence corporate choices about transformation.

Effects of Takeovers Depend on Acquirers' Strategy

- **Growth** (in markets or resources) – increase size of enterprise to reap economies of scale
- **Downsizing** – dispense with non-performing assets and refocus operations
- **Value Extraction** – get more out of existing assets by changing way they are managed

Canadians Versus Foreigners

- The *nationality* of the acquirer is *less important* than the rationale for the acquisition, its strategic business context, and the manner of deployment of strategy through changed company structures and decisions.
- Canadian and foreign acquirers behave similarly in Canada and abroad.

Corporate Takeover Effects (CTEs)

- *Corporate takeover effects* (CTEs) is the collective term for *the effects* (impacts and consequences)—positive, negative, and neutral—that result from changes to corporate control, governance, structure, functions and operations made by new owners after they take over a company.

"Hollowing Out"

- *"Hollowing Out"* refers to a subset of corporate takeover effects.
- It is the term for the *negative effects* (impacts and consequences) that result from changes to corporate control, governance, structure, functions and operations made by new owners after they take over a company.

Extent of CTEs

- The extent of actual corporate takeover effects—CTEs—depends on the nature of the post-acquisition *decisions* made by the new owners.
- Owners' decisions *may result* in a wide range of positive, negative, or neutral effects.

Types of CTEs: Effects on …

- Previous owners
- Governance
- Head office functions and responsibilities
- Professional services acquisition
- Line management
- Operations
- Employment
- Capital spending
- Community involvement

Report Findings: Corporate Takeover Effects (CTEs)

1. Shareholders
2. Governance
3. Management
4. Operations
5. Capital
6. People
7. Community

CTEs - Shareholders

- Receive average premium of 27 per cent.
- Foreign takeover premiums 28 per cent, Canadian 26 per cent.
- Billions annually inflow from foreign acquirers to Canadians while acquirers assume risk (e.g. AMD recent takeover of ATI - $4 billion loss in one year).
- Huge financial reward which can be utilized elsewhere in the economy.

CTEs - Governance

- Existing governance is normally completely “hollowed out” as firms are normally taken private and subsumed under new owners’ boards.
- Boards of directors disappear – true for both foreign and Canadian takeovers.
- Stocks are de-listed.

CTEs - Management

- Effects are far more varied.
- In some instances, there are positive effects – senior management grows at ‘head office’.
- More often, senior management is reduced.
- Average effect in case studies was ‘moderate negative’ effect.

CTEs - Management

- Yet, *macro* head office numbers are not down.
- Cities with most takeovers see most head office growth.
- Pay levels for high-level professional services show no signs of decline.
- *No empirical macro evidence* to support views that takeovers lead to fewer quality jobs or reductions in quality of jobs – further study needed.

CTEs - Operations

- On average, operations experience slight positive effects from takeover – especially foreign takeovers.
- Reason: product and geographic overlap of businesses is less with foreign owners so there is less *business* need to remove redundant capacity than with Canadian acquirers.

CTEs - Capital

- On average, capital investment by foreign owners results in moderate positive effects for Canadian firms taken over.
- Foreign firms invest in R&D, expansion, are larger on average and so have readier access to capital.

CTEs - People

- On average, takeovers result in slight positive effects.
- Employees are retained, often some new hiring, net result slightly more jobs.

CTEs - Communities

- On average, community effects are minimal (but evidence is limited).
- A few takeovers result in increases in community involvement; a few in declines.
- *Not a priority* in corporate planning in relation to takeovers.
- Removal of CEO can have broader community impact on charitable/not-for-profit fundraising.

CTEs: Summary

- Overall, CTEs are positive for shareholders, mildly positive or neutral for operations, capital, people, and community involvement, and negative for governance and management.

Canadians Versus Foreigners

In Canada

- Canadian acquirers' actions result in *slightly more* negative **corporate takeover effects** (CTEs) ("hollowing out") than foreign acquirers – for business reasons.

Outside Canada

- Canadian acquirers' actions result in *similar* levels of negative CTEs abroad as do foreign acquirers' actions in Canada.

Sovereign Wealth Funds

- Canada is prominent in creating and operating sovereign wealth funds (SWFs) – e.g Alberta Heritage Savings Trust Fund.
- Our pension funds are widely viewed as SWFs although they deny this status.
- Substantial involvement in international infrastructure ownership, some hostile (e.g. NZ airport) – much more scale than foreign SWFs in Canada.

Level Playing Field?

- Canadian pension funds' higher level of activity internationally than foreign SWFs in Canada has implications for 'level playing field' discussions/negotiations.
- 'Reciprocity' as a strategy leaves us open for other complications – our firms make major purchases in sectors we protect at home.

State-Owned Enterprises (SOEs)

- State-owned enterprises (SOEs) should be treated as a special case because their actions are not exclusively market-driven.
- There are national security considerations at play (although so far most SOEs world-wide are focusing domestically).
- Potential for foreign governments to intervene in Canada through SOEs warrants special oversight, possibly restrictions

Part 3 – Why the Concern?

Debate is Not Strictly Economic

- Much of the "hollowing out" debate is not strictly *economic*—more about the relation between corporate activity and national welfare.
- Ideas of national sovereignty and security, mercantilism, statism, corporatism, trust are all factors in the debate.
- *Competitiveness* is not prominent.

National Sovereignty and Security

- Underpins idea that some aspects of society are best managed by the state, using government machinery.
- Some argue that foreign corporate takeovers undermine the ability of the state to exercise its sovereign power.
- Especially a concern in relation to State-Owned Enterprises (SOEs) as acquirers.

Mercantilism

- Economic theory that holds that a nation's well-being is best served by maintaining a positive trade balance with other nations.
- Mercantilists argue that government should play a protectionist role in the economy by promoting exports and discouraging imports, through tariffs and other means.

Statism

- Refers to the concentration of economic controls and planning in the hands of a highly centralized government.
- Central government intervention by regulation, taxation etc. which restricts free market activity in order to achieve objectives defined by political leadership on behalf of the state—purpose may be primarily non-economic.
- Significant as basis for view of corporations as state agents, projecting influence internationally.

Corporatism

- Seeks to aggregate interests of major societal parties into a social “contract”.
- It sees government, companies and major unions together directing policy in the national interest.
- Generally suspicious of newcomers and of the effects of foreign corporations.
- Underpins idea that foreign takeovers put us at risk since foreigners do not have same commitment to our system as do Canadians.

Part 4 –
Policy Recommendations

Policy Recommendations

Investment Policies

- In general, Canadian policies on foreign direct investment are sufficiently restrictive.
- Only introduce new foreign investment *restrictions* based on national security considerations, especially relating to state-owned enterprises.

Policy Recommendations

National Security

- Seek a regulatory “level playing field” without increasing economic protectionism, while paying close attention to national security issues.
- Base any new foreign investment restrictions on national security considerations especially in relation to state-owned enterprises.
- Caution on limiting foreign SWFs in Canada - Canadian pension funds are viewed by some internationally as SWFs and may be penalized.

Policy Recommendations

Investment Policies

- Examine liberalization of ownership and operating restrictions on foreign investors in protected sectors: *telecommunications, broadcasting, cultural industries, uranium production, transportation services, and financial services (required to be widely held)*.
- Consider liberalization *sector-by-sector*, bearing in mind the circumstances in each sector and general interests of Canadians.

Policy Recommendations

Business Environment

- Do not limit competition for capital and control of firms in Canada by restricting M&A activity. M&A is a positive part of the process of competition for capital and control.
- Continue to create optimal conditions for the creation and growth of companies, as with recently announced reductions in corporate income taxes.

Policy Recommendations

Communication

- Communication campaign to Canadians about the economic benefits of free capital flows. Canadians' ambivalence to FDI and M&A is unwarranted based on the evidence.
- Canadian pension plans should explain to their members how international capital flows will benefit them.

Policy Recommendations

Education

- Assist Faculties of Business and Management to become more global in their focus – to prepare business and management graduates for international business.
- Seek out Canadian entrepreneurs to mentor the next generation of Canada's global business people – to prepare them to find and seize business opportunities internationally.

Conclusion

- Transformation is vital to our economy: corporate takeovers have a valuable transformational role to play in improving economic performance.
- Canada is a ‘net beneficiary’ from rising M&A activity world-wide—we are successful at it.

Conclusion

- Canadian takeovers internationally help build larger, more competitive firms, thus enhancing our national competitiveness.
- Foreign takeovers in Canada bring much-needed capital and expertise, while costing governance and senior management jobs.
- Further investment liberalization (carefully done) is likely to bring us further benefits.

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