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Mr Norgrove
10 Downing Street
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23 December 1985

Dear David,

JUNK BONDS

Your letter of 20 November asked for a Treasury note on the growth in the use of junk bonds in the US for financing takeovers. You subsequently told me this would not be necessary, since you had been sent a copy of a paper on the subject by the Bank of England. Then, more recently, you said it would, after all, be helpful to have a paper which looked rather more at the possible implications for the UK.

We have now prepared such a paper, with help from the Bank of England and DTI. I attach a copy. It has annexed to it a rather longer paper by the Bank of England about US experience. As you will see the paper goes a little wider than the use of Junk Bonds, and examines the use of leveraged takeover bids more generally.

The paper suggest two broad conclusions:

- First, the institutional and tax conditions here are different from those that have led to the use of junk bonds in the US. They are not such as to be likely to encourage the growth of a junk bond market here. The UK takeover rules would also tend to prevent the use of this technique. Although the leading US company in this field (Drexel Burnham Lambert) have been trying to interest UK companies in the technique, they do not appear to be having any success.

- "Leveraged" takeovers financed by bank borrowing rather than bond issues do, however, take place in the UK, and have for many years. Such lending is likely to have a greater effect on the wider monetary aggregates than bond issues, unless the latter were bought by banks, but it is not easy to trace the

effects through. There could also be prudential implications for banks, and it is clearly important that the Bank of England supervisors should keep a check on banks' exposure to companies engaging in leveraged takeover bids.

I am copying this letter to John Mogg (Department of Trade & Industry) and to John Bartlett (Bank of England).

Yours ever
Rachel

RACHEL LOMAX

CONFIDENTIAL

THE FINANCING OF CORPORATE ACQUISITIONS : LEVERAGED TAKEOVERS

This note briefly sets out the latest state of play on attempts at regulating "junk bonds" in the US and the reasons why these bonds have not been emulated in the UK. Paragraphs 10-12 attempt to provide a broad estimate of the monetary effects of the recent level of takeovers in the UK. Attached is a copy of a recent Bank of England internal paper on takeovers and mergers.

Introduction

2. In the United States, a pattern of takeovers has emerged (often associated with the New York investment banking firm of Drexel Burnham Lambert Inc) under which takeovers are arranged by the would-be acquirer through the establishment of a "shell" company. The shell company issues bonds (called "junk" bonds because they are usually rated at Ba or lower by Moody's and BB or lower by Standard and Poor), secured against the stock it acquires in the target company, in order to buy the stock. This technique enables companies with a low capitalisation to take over companies with much larger ones, and has been one factor leading the latter to develop various devices to ward off hostile bids. (Such devices include "poison pills", for example arranging a loan to finance payments due, making it a term of the loan that it would be immediately repayable in the event of a takeover. This would face the purchaser with an unwelcome immediate outflow.) These tactics represent a special type of leveraged takeover, which is any takeover where a high proportion of debt is used to purchase the target company. Junk bonds can of course be issued for other purposes than takeovers.

The Proposed Federal Reserve Regulation

3. The recent publicity about the intention of the Federal Reserve to impose margin requirements on shell companies relates to takeover financing using junk bonds. Under the Fed's proposal,

they will be prevented from financing more than 50 per cent of a stock purchase with loans secured by the stock, and the Fed are accepting comments from the public on this proposal in the period up to 23 December. The Administration oppose what the Fed intend, but it nonetheless appears as if Mr Volcker will proceed without Administration backing, as he is empowered to do. Drexel Burnham Lambert has protested about the proposed change, but are also ready to adopt new approaches to get around any new Fed regulation. The new regulation will not affect the many forms of leveraged takeovers in the US besides those financed by low-grade bonds issued through a shell corporation. It may not affect, for instance, the activities of T Boone Pickens of Mesa Petroleum who is one of the most famous practitioners of leveraged takeovers.

Junk Bonds in the UK

4. The particular leveraged takeover technique outlined above is not at present a major factor in the UK. There is no market for low-grade bonds in the UK as there is in the US, since the obligations on trustees and other provisions in our legislation, and our supervision arrangements for banks, building societies and insurance companies, discourage pension funds and financial institutions from investing in low-grade bonds. We also lack the equivalent of money market mutual funds, which are one of the main ways US individuals can participate in the high yield bond market while spreading their risks. Further, the UK does not have a tax provision for individuals similar to Individual Retirement Accounts, whereby Americans can invest up to $2,000 per annum (or the amount of their earned income, if less) in securities the income on which may be rolled-up and taxed only on withdrawal (there is a small extra penalty charge on withdrawals before retirement).

5. Therefore the conditions do not exist here for a low-grade bond market equivalent to the one in the US, which has led to $35 billion in high yield debt, yielding up to 4 per cent above those on "investment grade" bonds, having been issued there in

the period 1977-1984. Nor have bidders for UK firms so far tapped the US junk bond market (at least on any scale) and switched the proceeds into sterling.

6. The takeover rules are also probably on balance more restrictive as they affect hostile bidders in the UK: in the United States "two-tier" offers are possible under which one price is paid for the first 50 per cent of stock acquired and a lower one for the second 50 per cent. Short time limits for acceptance of offers can also be used as a tactic in the US, although to comply with the Williams Act the minimum offer period has to be more than twenty business days. It is hard to mount a defence or counter-offer in so short a period.

7. But the fact that the particular method of effecting leveraged takeovers now being regulated against in the US is not at present a significant factor here (although Drexel Burnham Lambert would like to extend their operations to the UK) is not to deny that over the past two years UK takeovers have been accelerating in total value, and that some of them are highly leveraged. The net result of this may be to leave targeted companies saddled with large debts if bids are successful. As in the US, this in turn may lead to corporate raiders selling off the assets of the target company in order to pay off the debt incurred in purchase.

The Financing Pattern in the UK

8. It is not easy to assess the financial effects of takeovers. Even the presumption that bond or equity finance will have less effect on monetary growth than direct bank lending has to be examined in each case, since a large proportion of the securities concerned might, in principle, be taken up by the monetary sector. But aggregate data for even the primary financing arrangements for takeovers in the UK are not available in any great detail. The Office of Fair Trading, for instance, have very little relevant material. Any thorough investigation would therefore have to be a special exercise. The overall pattern can be only broadly

estimated on the basis of DTI figures, which do not trace the ultimate source of cash used in takeover transactions.

9. There could of course be more substantial grounds for concern over the growth of takeover finance in debt form. A series of takeovers financed by debt, apart from their possible effects on industrial concentration and structure, which may not necessarily be at all harmful, could alter the balance between corporate debt and equity in an undesirable way. Effective banking supervision has an important role to play here, and should prevent unhealthy exposure by banks through involvement in leveraged takeovers and management buyouts.

10. It is known that direct bank finance has been a large element in such recent attempted takeovers as Elders/Allied (where a shell company, IXL, has been set up as an intermediary) and Argyll/Distillers. In the case of Elders/Allied foreign banks have agreed to provide the finance and certain US banks such as Citibank now operating in London have a strong expertise in this general field. Other geared bids (Hanson/Imperial) have featured issues of loan stock convertible into equity later. (In both the Hanson/Imperial and GEC/Plessey cases, however, the acquirers have sufficient cash not to be seriously affected by the pressures of high gearing.) A large increase in gearing may be even more characteristic of management buyouts than of corporate takeovers. The Molins buyout, for instance, would have - if it had gone through - raised gearing from 9 per cent to over 90 per cent.

11. The overall position on financing takeovers in the UK (see Annex A) is that during 1980-84 about 55 per cent of the purchase price has been financed by the cash, about 39 per cent by the issue of shares, and about 6 per cent by the issue of fixed-interest securities. It is unknown what proportion of the cash used in UK takeovers is raised by special issues of debt instruments. With the notable IXL exception, it is unusual here for a shell company to be set up to facilitate a takeover (although this seems to be more common in the case of management buyouts)

and the total amount of fixed interest debt issues for all purposes is not large. The major source of credit in the UK is the banking system, and bank lending to finance merger activity takes place on a fairly large scale to borrowers that appear to loan managers to be creditworthy.

12. The total value of acquisitions and mergers within the UK in 1984 was about £5.5 billion; 54 per cent of it financed in cash. The pace of takeover activity has accelerated this year, and in the first three quarters of 1985 the total value of takeovers was £6.1 billion, of which perhaps 40 per cent or £2.4 billion was in cash. A significant proportion of these cash figures could have been financed by bank lending, though the ultimate impact on aggregate bank lending and the money supply will depend on how quickly these loans are repaid, and what the recipients of cash offers do with the proceeds. Some will go to reduce bank borrowings; some to avoid the need for borrowing that would otherwise have taken place. And bank lending for this purpose will to some extent replace lending for other purposes.

13. The progressive reduction in the rate of Corporation Tax from 52 per cent in 1983-84 to 35 per cent in 1986-87 should tend to discourage the use of bank borrowing and other debt financing for takeovers as interest tax deductions become less valuable. But until the current takeover boom subsides, it is likely to outweigh this and other factors which might tend to reduce bank finance for takeovers.

Conclusions

14. There are significant differences between the institutional conditions in the UK and the US, and between the tax laws of the two countries. The conditions which have encouraged the growth of a junk bond market in the US do not obtain in this country. In particular, the UK takeover rules would tend to prevent the use of junk bonds in leveraged takeovers in the UK. However, leveraged takeovers financed by bank borrowing rather

than bond issues have taken place in the UK for many years. There are implications in this for the wider monetary aggregates, but it is not easy to quantify the effects. More important is the prudential aspect. The banking supervisors need to maintain checks on banks' exposure to companies engaging in leveraged takeover bids. So far, there are no grounds for belief that this is a problem, but it is clearly important to keep this under review.