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10 DOWNING STREET

From the Private Secretary 10 March 1986

JUNK BONDS

The Prime Minister has seen your letter to me of 5 March. She was grateful for the report attached to it which discussed aspects of highly leveraged takeovers which are of particular concern to the Department of Trade and Industry.

Paragraph 19 of the attachment said that the DTI senior management would shortly be reviewing the broad relationship between the City and industry. The Prime Minister would be interested to see a report on this work in due course.

I am copying this letter to Philip Wynn Owen (Treasury) and John Bartlett (Bank of England).

(David Norgrove)

Michael Gilbertson, Esq.,
Department of Trade and Industry.

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Secretary of State for Trade and Industry

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PS/

5 March 1986

David Norgrove Esq
Private Secretary to
the Prime Minister
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LONDON
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Prime Minister
An interesting note.
I shall ask for a report on the intriguing reference in paragraph 19, when it is ready.
DRN 7/3.

Dear David,

JUNK BONDS

In your letter of 29 January, you said that the Prime Minister would be interested to see the results of the work set in hand here on those aspects of highly leveraged takeovers of particular concern to this Department.

... I enclose the report on those issues which our officials have prepared and which has been endorsed by Ministers here.

As with the work undertaken in the Treasury and the Bank of England, our studies were prompted by reports of the tactics employed in leveraged takeover bids in the United States; and by indications - particularly the Elders/IXL bid for Allied Lyons - that leveraged takeovers might be catching on here.

The aspects identified as being of particular concern to the DTI are:-

a) Competition.

b) Investor protection, as regards the shareholders both of the bidder and of the target.

c) The substitution of debt for equity in the individual case (as distinct from the potential global problems identified by the Treasury and the Bank).

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Our conclusions are summarized at the beginning of the paper. Briefly, they are as follows:

i) Leveraged takeovers do not typically pose competition problems. Subsequent asset disposals may do. When they do, they should be examined rigorously under the mergers legislation.

ii) The relevant statutes, and the Takeover Code, seem adequately to protect the investors.

iii) the chances that a leveraged takeover may go wrong, and harm the interests of employees and third parties, may in a few cases justify Government intervention.

iv) The obvious means of intervention is reference to the Monopolies and Mergers Commission.

The competition policy issues will arise again in the course of the proposed review of competition law and policy, about which the Secretary of State wrote to colleagues on 20 February, and which is to be discussed in E(A) at the Prime Minister's request.

The paper also touches on the argument that the threat of a leveraged takeover may concentrate management attention too much on the short term; this is part of the wider question of the City and Industry which the Department will be considering separately.

I am copying this letter and attachment to Philip Wynn Owen (Treasury) and John Bartlett (Bank of England).

Yours ever,
Michael

MICHAEL GILBERTSON
Private Secretary

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LEVERAGED TAKEOVERS AND BUYOUTS

Summary of Conclusions

1. a) Leveraged takeovers do not themselves typically pose competition problems; but it will be necessary to make clear that subsequent asset disposals may be examined rigorously under the mergers legislation (Para. 6).

b) The interest of shareholders both of the bidder and of the target of a leveraged takeover seem to be adequately covered by statutory provisions and by the Takeover Code. (Para. 12).

c) The global effect of a series of large leveraged take-overs on bank lending and on financial markets generally could become a problem; but it would be one for the Treasury and the Bank of England, not the DTI (Para. 16).

d) The danger that a particular leveraged takeover may turn out badly and in doing so, bring adverse consequences for employees, third parties, and the local or national economy, may in rare cases justify Government intervention (Para. 17).

e) The obvious means of intervention is by reference to the MMC: but this has limitations, particularly in relation to management buyouts. (Para. 18).

f) There is no reason to rush into new decisions of general policy on leveraged takeovers ahead of the MMC report on Elders/Allied (Para. 18).

g) The alleged effect of the threat of leveraged takeovers in concentrating management attention on the short term is best addressed separately, as part of wider consideration of 'The City and Industry'. (Para. 19).

Introduction

2. There has been a flurry of interest in recent weeks/months in 'leveraged' or debt financed takeovers. The subject has become topical for several reasons. There have been in the last year or two a succession of spectacular takeover battles in the United States, some of them involving attempts by smaller companies, or individual

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'corporate raiders', to acquire much larger and better established companies. A favourite technieque has been to finance such acquisitions by the issue of bonds of less than investment quality ('junk bonds') secured in effect on the assets of the company created by the merger. On 8 January 1986 the US Federal Reserve Board stepped in, reputedly against the wishes of the US Administration, to restrict junk bond financing by limiting it to 50% of the purchase price where an acquisition is carried out through a 'shell' company.

3. The spate of very large merger proposals announced in the last weeks of 1985 - Imperial/United Biscuits; Hanson/Imperial; Elders/Allied; Argyll/Distillers, GEC/Plessey, - prompted speculation whether US-style takeover battles were coming here, though only in two cases - Elders/Allied and Argyll/Distillers - was 'leveraging' a factor. Merger activity has in fact been rising throughout 1984 and 1985, compared with the preceding years, and the increase has been heavily concentrated in the food, drink and tobacco and retailing sectors. The reasons for this are a matter for speculation, but one plausible suggestion is that in these sectors it has become difficult for a dynamic company to grow except by acquisition. It has also been suggested by some that increasing confidence that mergers will be referred to the MMC on competition grounds only has been seen as a green light to conglomerates to expand by acquisition.

Definition

4. A leveraged takeover might be defined as a takeover, financed largely by debt and creating a new company with a high 'gearing' (debt/equity) ratio. A more extreme definition would restrict the term to cases where the resulting gearing ratio is unsustainable so that the bidder would be committed from the start to selling off many of the assets of the company acquired. But most of the concerns voiced about leveraged takeovers are not confined to this exteme case. A leveraged buyout may be defined as the acquisition of a company, or part of a company, from the shareholders by the management, financed wholly or mainly by debt and producing a high gearing ratio.

Possible Areas of Concern

5. These can be summarised as follows:-

i) Competition.
ii) Investor protection.
iii) Substitution of debt financing for equity.

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I. COMPETITION

6. So far as the possible restriction of competition is concerned, a leveraged takeover is no different from any other sort of merger. If it meets the statutory criteria, it can be referred to the MMC. There may be cases where the takeover is followed by disposals to third parties which themselves raise competition issues. These, too, can be examined under the competition legislation separately at the time. Sometimes disposal plans may be sufficiently well formulated for them to be considered at the time of the original takeover. But it is not practicable to insist at that stage on a complete statement of the bidder's disposal plans. A difficult situation might arise if the viability of the original takeover depended on a disposal to a particular third party which was then referred to the MMC. If such a development seemed possible, it would be important for OFT, or the Department, to make clear to the bidder from the outset that a reference of such a disposal was not ruled out. Whether a leveraged buyout falls within the terms of the mergers legislation will depend on exactly how it is structured. But it is unlikely to pose any competition problems; indeed, a management buyout often has the character of a de-merger.

II. INVESTOR PROTECTION

7. The conduct of leveraged takeovers in the USA has been alleged to be detrimental to the interests of shareholders both of the bidder and of the target. But there are important differences between the situation there and here, arising from:-

a) the provisions of company law

b) the Stock Exchange rules

c) The Takeover Code

d) the predominance of institutional shareholders

The particular points at which the interests of investors might come under threat are considered below:-

i) <u>Threats to the Interests of Shareholders of the Bidder</u>

8. If successful, a leveraged takeover results in a company with a high gearing ratio, at least for a time, and places the shareholders in a correspondingly exposed position. The following provisions appear to protect the interests of shareholders of the bidder who do not want to be put in this situation:-

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a) In the case of a listed company, Stock Exchange rules require shareholders to be informed of any transaction under which assets are acquired representing 15% or more of the company's assets. When this figure is 25% or more, the approval of shareholders is required.

b) If the debt is in a form convertible into shares, S.80 of the Companies Act applies. Such securities can only be issued if the directors are authorised to do so by the company's articles or by a general meeting.

c) S.459 of the Companies Act enables a shareholder to apply to the court on the grounds that the company's affairs are being conducted in a way prejudicial to his interests.

These, and particularly a), seem to afford shareholders adequate protection. Where the institutions hold a significant proportion of the shares they are equipped to take a professional view of the gearing involved in the takeover, and exercise their rights as shareholders if they do not like it. This provides some protection for the interests of individual shareholders ill-equipped to make such assessments.

ii) Threats to the Interests of the Shareholders of the Target from the Actions of the Bidder

9. The shareholders of the target are not at risk if they accept a cash offer or sell in the market. They can only be forced to accept the bidder's paper if they are part of the residual 10% after 90% of shareholders have accepted. Even then, they have the option of accepting any alternative offer, even one which has lapsed. (S.428 of the Companies Act). And they can require the bidder to buy them out (S.429). The Financial Services Bill clarifies and strengthens the position of shareholders in this situation, which is in any case not peculiar to leveraged takeovers.

10. The other main safeguard for the shareholders of the target is the Takeover Code requirement that a bidder who has acquired a 30% holding must then buy out the rest at a fair price. There is no equivalent rule in the US, and much of the threat posed there by leveraged takeovers results from the bidder's ability to gain control through a partial offer. But it should be noted that protection in the UK is without statutory basis.

iii) Threats to the Interests of the Shareholders of the Target from the Actions of their own Directors

11. Defensive measures against unwanted bids have evolved rapidly in the US, largely in response to leveraged takeovers, though there

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is no logical connection. Tactics include the sale of selected assets to a third party, to become effective if the bid succeeds; (poison pills). Some bids have been repelled by the target company repurchasing shares from the bidder at a high price (which may have been all the bidder intended). The UK's more restrictive rules about companies purchasing their own shares make such expectations harder to realise, and therefore less likely to be entertained. Stock Exchange rules (cf paragraph 8a above) apply to major disposals of assets.

12. The above safeguards, and the ability of institutional shareholders to use them effectively, seem capable of protecting London from the worst excesses seen in the US. The Financial Services Bill contains provisions which give statutory force to Listing Rules made by the Stock Exchange. The Takeover Code will remain on a non-statutory footing.

III. SUBSTITUTION OF DEBT FINANCING FOR EQUITY

13. Recent leveraged takeovers and buyouts in the USA have involved the creation of several billion dollars of new short term corporate debt each. In the UK, the recent spurt of merger activity has included bids which would each create more than £1bn of such debt here. The form for such debt however differs according to local custom and practice. In the US, 'junk bonds' have become common. Junk bond financing of takeovers has not developed in the UK, and this can be explained by institutional and legal differences between the situation here and in the United States. In particular, the restrictions on the investments permitted by a trustee, and the supervision arrangements for banks and building societies, effectively discourage the major institutions from investing in low grade corporate bonds, and it has not therefore been possible for a market in 'junk bonds' to develop. This is not likely to change quickly, though the leading exponent of 'junk bonds' in the US - Drexel, Burnham, Lambert - are said to be interested in starting a market in junk bonds in the UK.

14. Other forms of debt financing of takeovers are familiar in the UK, namely:-

i) the issue of loan stock, convertible into shares at a later date

ii) the offer of cash, some or all of which is borrowed by the bidder from banks.

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15. Debt financing of takeovers, of any of these kinds, has given rise to concern on two distinct grounds:-

a) that a series of such takeovers might shift the overall balance of corporate financing in the UK away from equity and towards debt to an extent which might lead to over-exposure on the part of the banks involved, and de-stabilise financial markets more generally.

b) that in each individual case the gearing of the company formed by the merger will leave it too exposed if its trading experience proves less favourable than was assumed at the time of the bid, or interest rates rise. This might lead to decisions being taken under short term pressure, notably on asset sales, which might be against the company's long term interests; and even, in the extreme case, to the failure of the new company.

16. The first of these problems - the global one - seems to have been what prompted the Federal Reserve Board early last month to impose margin restrictions on junk bond financing. But if it is a problem, it is one for the Treasury and the Bank of England rather than for the DTI. Any tendency for banks to become over-exposed should be picked up by the improved bank supervision arrangements announced recently; and it would also be for the Bank and the Treasury to deal with any excessive expansion of corporate borrowing. (The 1984 reform of corporate taxation including the reduction of corporate tax to 35% will in any case have reduced the relative attraction of debt financing).

17. The possible consequences of over-gearing in the case of the company resulting from a particular merger include:-

i) forced sale of part of the business, over and above sales planned at the time of the bid

ii) closure, on short term financial grounds, of parts of the business currently unprofitable but thought to have long term potential

iii) scaling down of expenditure with long-term rather than short-term payoff - research, development, marketing, training, etc.

iv) rapid rundown of inventories, possibly with adverse consequences to suppliers or competitors

v) in the extreme case, liquidation, accompanied by distress sales of the various parts of the business.

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There is a strong argument that it is not for the Government to intervene to protect the directors or the shareholders from the consequences of commercial misjudgment - or misfortune - of this kind. But there can also be adverse results for employees, suppliers, competitors, and for the local or even in some cases the national economy which are more arguably a proper concern of Government. The decision to refer the Elders/Allied takeover proposal to the MMC was an implicit recognition that, in some cases at least, a high degree of leveraging may give rise to uncertainty about the prospects for the resulting company, and that in such cases there may be dangers other than to the directors and shareholders which justify intervention.

18. If it is accepted that leveraged takeovers can raise issues of proper concern to Government, because of the wider consequences if they go wrong, the question arises how the Government should intervene. The obvious answer, exemplified by Elders/Allied, is reference to the MMC. Any leveraged takeover large enough to give rise to wider concern will meet the assets criterion in the mergers legislation. But there are limitations:-

a) The MMC and OFT are geared primarily to handle issues of competition, though they can deal with any other aspect of the public interest which may arise on a merger. If, as a result of a series of leveraged takeovers, leveraging loomed almost as large as competition as a basis for concern about the public interest in merger cases, one might have to review the adequacy of the legal and institutional framework for dealing with such mergers.

b) The mergers legislation may not, except fortuitously, catch leveraged management buyouts. The Government has tended to look kindly on such buyouts as a way of breathing life into the sleepy corners of large companies, and enabling enterprising management to secure appropriate rewards. But a large leveraged buyout which goes wrong can have the same consequences as a leveraged takeover.

However, alternatives to reference to the MMC, whether they take the form of a separate procedure for case by case examination of leveraged takeovers and buyouts, or devising restrictions of general application on the permitted degree of leveraging, are unappealing. The MMC report on Elders/Allied can be expected to discuss the public interest aspects of leveraged takeovers in some depth; there seems no need to rush into new policy decisions on the subject in the meantime.

19. One final point which has been made about leveraged takeovers is that the ever-present threat of such a takeover, from a hitherto unknown predator, is likely to make management concentrate on measures designed to maintain a high share price in the short term, to the exclusion of planning for the longer term. But this is part of the wider question whether stock market pressure, and notably the pressures on the institutions to demonstrate good short term performance, make it harder for management in the UK than for some of our competititors, to devote financial resources and management time to longer term aspects of the business. This is a much wider question than leveraged takeovers. The Department's senior management will shortly be revewing the broad relationship between the City and industry, and the issue of short-term pressures can more appropriately be considered in that context.

DEPARTMENT OF TRADE AND INDUSTRY

February 1986

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