Corporate restructuring in Britain and Germany

edited by Geoffrey Owen and Ansgar Richter

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4 The German market for corporate control: structural development, cross-border activities and key players

Günter Müller-Stewens and Michael Schäfer

Historical background and structural framework

The German market for corporate control could have been compared to a sleeping giant for many years. Numerous analysts and market players agree that it has the largest potential among European countries. What are the forces which have been hindering a more dynamic development, and what are the signs that encourage a more bullish view for the future?

From a historical perspective, the evolution of the German market for corporate control was triggered by the merger wave in the USA in the 1980s and began shortly after the evolution of its British counterpart.

A major impediment to a strong mergers and acquisitions (M&A) culture has always been an underdeveloped equity market. The reconstruction of the German economy after World War II was primarily financed by debt, and therefore the number of publicly traded companies has been traditionally low. Today there are about 700 listed German companies compared to 7300 in the USA and 1800 in Great Britain.

Another factor which has been slowing down M&A activity in Germany is the major role of banks in corporate governance. This influence has been substantially discussed and criticised and in essence stems from three sources. Due to their important role in financing German companies after World War II, German banks gained numerous seats on the supervisory boards of their clients and hence have yielded a substantial influence on the composition and decisions of executive boards. In parallel, banks accumulated large equity stakes in industrial companies. In addition, they execute the voting rights for many individual shareholders at the annual meeting (proxies). The predominantly conservative attitude of the German banks and other long-term-oriented institutional investors makes it very difficult to identify a suitable target for a public takeover. This argument is further substantiated by the fact that individual shareholders hold a majority of votes only in few listed German companies.

With its institutional form of corporate control, Germany lacks a tradition of hostile takeovers, which is surprising to a certain extent since German companies have been involved in numerous takeover bids – albeit as bidders – and resistance grows only when a German company is the target of such an 'assault'. The example of the Krupp–Thyssen case recently showed the difficulty of such an undertaking, especially with the additional threat of a political intervention. Another problematic aspect of the German banks' omnipresence has been highlighted by the conflict of interests which arises when a bank has close relations with

both sides involved in an acquisition process. It is impossible to build Chinese walls within individuals.

The Krupp–Thyssen case underlined the importance of the ongoing discussion about the competitiveness of the German capital market and there have been louder and louder calls for a reduction of the banks' power by limiting their position in corporate governance. Other legal measures relevant to the M&A field which will mostly strengthen the German capital market have been taken recently or are planned for the near future:

- In January 1995 insider trading was legally regulated for the first time and included in the German Securities Trading Act or *Wertpapierhandelsgesetz* (WpHG).
- At the same time, the immediate publication of any information with a potentially significant influence on the stock price was made mandatory in the WpHG.
- In October 1995 a comprehensive takeover code was published by the Ministry of Finance's Stock Exchange Commission. The code is voluntary and has been implemented by contractual recognition by potential offerors, target companies, and companies engaged in share dealing. The code provides rules concerning public takeover bids and aims at the protection of the shareholder's interests.
- An ongoing discussion is dealing with the allowance of share buy-back programmes.
- A tax reform will abolish the 50% tax reduction on gains from company sell-offs up to a value of DM 30 million.

The development of the German M&A market was fundamentally influenced by the invasion of the US investment banks, followed soon afterwards by British merchant banks. In contrast to the German *Universalbanken* which have long-lasting relations with their clients, investment banks live in a more deal-oriented environment. The arrival of these investment banks led to the foundation of a new profession in Germany – the M&A adviser. This in essence led to two different consequences:

- On the one hand, the German market for corporate control and the M&A services offered have become more professional. This process has been going on for almost two decades.
- On the other hand, the more aggressive approach of the US and British M&A advisers led to the initiation of a substantial number of transactions. The active search for ideas for advantageous acquisitions increased the large-scale transactions and facilitated the restructuring of major companies. As of today, many M&A consultants pool their know-how in industry teams. This practice increases the number of ideas and actual deals in the industries concerned.

The German banks realised that there were vast opportunities in the M&A field and responded to the activities of the market entrants in two ways. In order to be able to offer M&A services some banks acquired established foreign players: for example, Morgan Grenfell was acquired by Deutsche Bank and Kleinwort Benson by Dresdner Bank. Other banks decided to found their own M&A subsidiaries and acquired the know-how by hiring M&A experts. The organisational separation of M&A activities from traditional banking can be seen as an attempt to keep the different cultures apart, but also as an attempt to reduce the potential for conflicts of interest between the two areas of business. A third group of M&A advisers is made up of small consultancy companies which were founded by M&A experts formerly working for the established players.

In general, the British and US players concentrate on the upper segment of the market, which includes the largest listed companies, and are able to provide value added in the process of cross-border transactions and public takeovers. The smaller M&A advisers focus more on the upper part of the German *Mittelstand* which is increasingly becoming an attractive segment in the M&A market.

Although it is the large transactions that have tended to make the headlines, the vast majority of transactions involve companies from the *Mittelstand*. The consequences are twofold. First, since the volume of a typical transaction does not justify an M&A adviser's fee, about 85–90% of the transactions are done without one. Second, the conservative attitude of the *Mittelstand* (this also holds for many listed companies) towards their information policy results in a low transparency of the German market for corporate control which is reflected in a low availability of deal information and especially transaction prices. Therefore, reliable statistics on the German M&A market only include numbers of transactions.

In the following section we will further analyse the development of the market and show some current trends.

Market development – figures and trends

The German market for corporate control has been very stable for many years and M&A activities began to increase only in the mid-1980s. At this time the driving force for a more active acquisition policy among German firms was the advent of the Single European Market in 1992. The German M&A market reached its all-time high[1] in 1989, with more than 2800 transactions (Figure 4.1).[2] In the following years, the figure dropped to a low of 2200 transactions in the recession of 1993. Thereafter, it increased to 2700 transactions in 1995 but did not reach a new record level, in contrast to most of the foreign M&A markets.

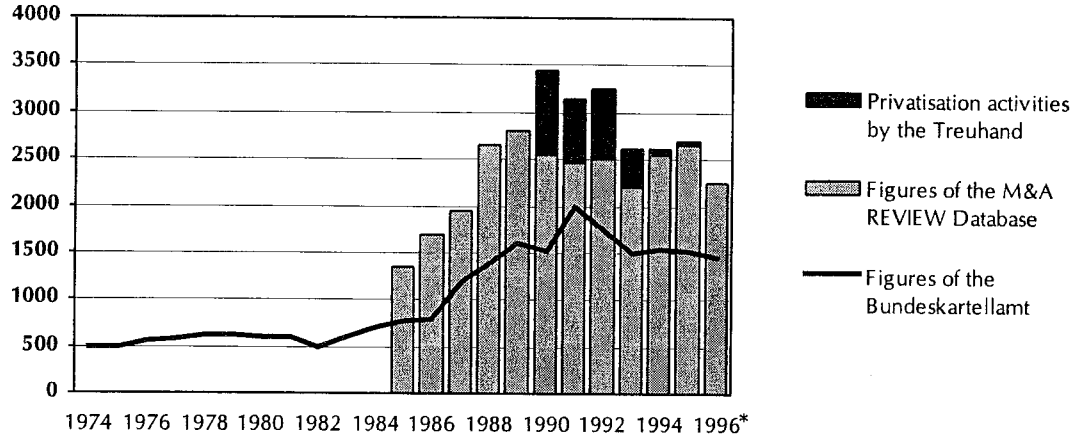
Since the acquisition wave caused by the formation of the Single European Market many German companies have taken measures to reduce costs and improve efficiency which were triggered by the recession of 1993. Downsizing and delayering programs have been launched and at the moment almost every company is talking about concentration on core business and divestment of non-core activities. These efforts have to be seen as a reaction to the growing popularity of the shareholder value concept which is putting more and more pressure on German companies to increase their profitability. Well-known examples are Thyssen and Siemens which recently announced the active screening of their portfolios. As a result of this general trend, many businesses or business units are up for sale and provide for a surplus of supply in the market of corporate control which drives prices down.

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[1] Neglecting the privatisation activities in the early 1990s.

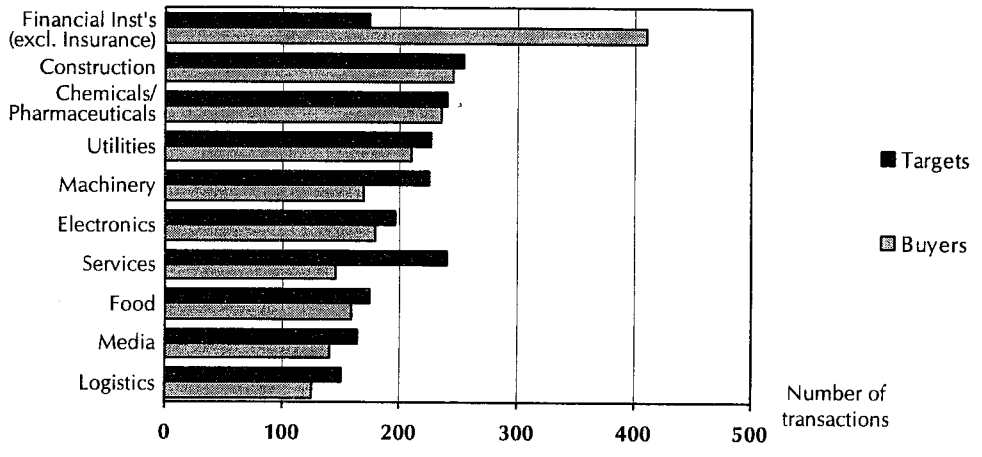
[2] Numbers of transactions include acquisitions announced to the *Bundeskartellamt* (i.e. minimum stake of 25%), acquisitions published in the daily press (including the purchase of minority stakes) as well as joint ventures.

Figure 4.1
Development of the German M&A market



Source: M&A REVIEW Database. *as of 01.05.1997

Figure 4.2
German M&A activities by industry (average number of transactions between 1989 and 1996)



Source: M&A REVIEW Database.

However, the same companies are also starting to look for suitable target companies to strengthen or broaden their core activities. Many are striving for a critical mass and are trying to become top players in their business, if not market leaders. However, this 'more of the same' policy raises the question whether the reduction of variety will not result in a loss of innovative capabilities.

An analysis of industry activities shows that the key industries (Figure 4.2, excluding the automotive industry) have always played an important role since both the number and the relevance of transactions have traditionally been substantial. Other industries show even higher numbers, but the importance of the underlying deals has been lower on average: in the

utilities industry, most deals are acquisitions or foundations of local energy or waste/recycling companies; most of the acquisitions by financial institutions are investments with a minority stake; and in services, most targets are real estate companies or industry-related consulting firms.

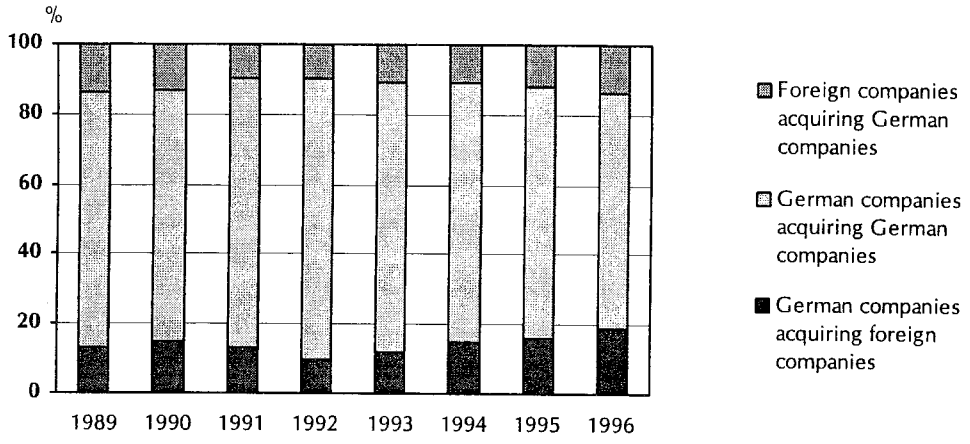
Recently, a large merger wave has captured the chemicals and pharmaceuticals industry, making this segment the busiest playground for M&A activities. Ongoing consolidation efforts were certainly accelerated by the announcement of the Swiss mega-merger involving Ciba-Geigy and Sandoz. As a result, all major German players are restructuring their business. Hoechst has been among the most active companies and is focusing its business on three different areas – pharmaceuticals, agrochemicals, and industrial chemicals. In order to strengthen these businesses, Hoechst acquired – among others – the US pharmaceuticals company Marion Merell Dow (1995, DM 10 billion) and the French pharmaceutical company Roussel-Uclaf (DM 5.4 billion for the remaining 43.47%). On the other hand, Hoechst disposed of its cosmetics division consisting of Jade, Marbert, and Schwarzkopf (1995); its printing division, which was acquired by Agfa-Gevaert (1995, DM 700 million); and significant parts of its speciality chemicals activities – the 95.77% stake in Riedel-de Haën was sold to Allied Signal (1995) and the remaining activities will be given to the Swiss Clariant. In return, Hoechst will receive a 45% stake in the Swiss company which will also take over liabilities from Hoechst (1996, total volume of DM 8 billion). The result of these efforts cannot be assessed yet but it is discernible that more and more restructuring programs include M&As as an integral part.

On the corporate level, one of the most active players in recent years has been Daimler-Benz. Guided by the vision of the former chief executive, Edzard Reuter, Daimler tried to build a so-called 'integrated technology company'. Within a few years, Daimler acquired AEG (1986, electronics), MBB (1989, aviation/space technology), and Fokker (1992, aviation) to complement its traditional activities with a focus on the automotive business. However, the delegation and separation of the transaction and integration activities proved to be disadvantageous. In particular, the effort required for a successful integration was seriously underestimated. As a consequence, the expected synergies could not be realised, the exchange of technological know-how was disappointing, and the vision failed. Finally, Daimler reformulated itself as a 'mobility company' and divested Fokker and most of AEG. In the process, Daimler accumulated losses of DM 8 billion, not to mention the enormous managerial effort wasted which could have been allocated more effectively to other areas. The example of Daimler stands for many unsuccessful large-scale transactions between German companies. Certainly, it has been closely followed by foreign observers and has been widely seen as a representative example of the extent to which German companies are successful in their restructuring efforts.

Cross-border activities

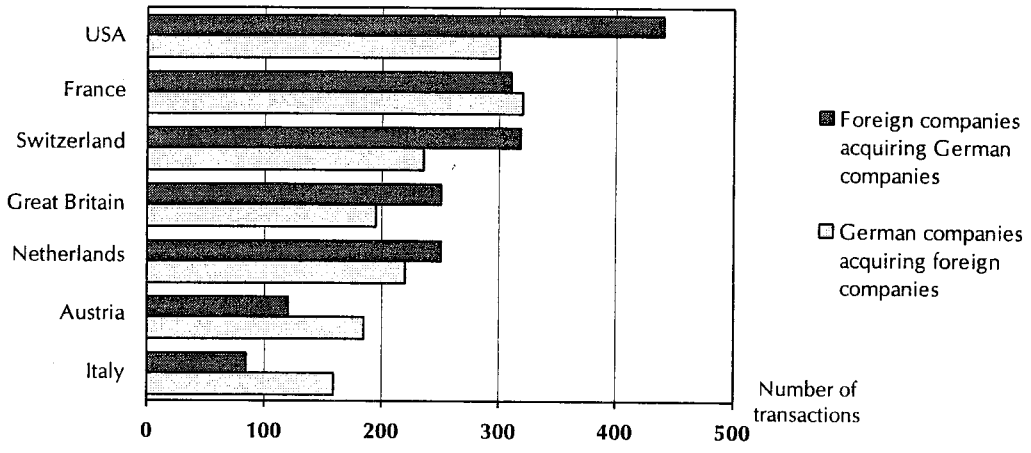
The first noticeable cross-border transaction involving a German company was the acquisition of the US supermarket chain A&P by Tengelmann in 1980, and such activities have played an important role in German M&A ever since. The share of cross-border transactions since 1989 has never dropped below one-fifth of the total market and in the last two years it has settled at about one-third (Figure 4.3). Over this period, more foreign companies were bought by German companies than the reverse, although this was not the case in every year.

Figure 4.3
The role of cross-border activities in the German market for corporate control



Source: M&A REVIEW Database.

Figure 4.4
Most active buyer and target countries in German cross-border transactions



Source: M&A REVIEW Database.

Even more important than the number of cross-border transactions is their size. The list of large German deals in Table 4.1 shows that in most cases a foreign company was involved. Furthermore, it becomes clear that the acquisition of large foreign companies by German firms outweighs deals in the opposite direction. This is not surprising since Germany has been a net exporting country of investment capital for many years.

A further geographical breakdown reveals that the countries that invested most in German companies were exclusively industrialised countries, with the USA in first place, followed by France, Switzerland, Great Britain and the Netherlands (Figure 4.4). Interestingly, with the exception of France, these countries show a strong positive balance in the number of acquisitions with Germany. German companies, however, invested heavily in Austria, Italy, eastern European countries such as Hungary and Poland, and China.

Table 4.1
Selected German transactions since 1985

Year	Buyer	Target	Industry	Stake	Price
1985	Continental AG	Semperit (A)	Tyres	75%	<DM1bn
1986	Bertelsmann AG	Doubleday & RCA Records (USA)	Media	100%	DM1.6bn
	Daimler-Benz AG	AEG	Electronics	56%	$900m
1987	Hoechst AG	Celanese (USA)	Chemicals	100%	DM5bn
	Continental AG	General Tire (USA)	Tyres	100%	DM2bn
1988	Metro	Kaufhof	Retailing		
	RWE	Deutsche Texaco	Oil	100%	$1.2 bn
1989	Siemens AG	Plessey Co. Plc (GB)	Electronics	100%	DM4bn
	Deutsche Bank AG	Morgan Grenfell Plc (GB)	Banking	100%	DM2.66bn
	Daimler-Benz AG	MBB	Aviation/space technology	45.16%	DM1bn
	Preussag AG	Salzgitter AG	Steel	100%	DM2.5bn
1990	Stora (S)	Feldmühle Nobel	Chemicals/Paper	97%	DM4.2bn
	Allianz AG	Firemen's Fund Insurance Co (USA)	Insurance	100%	DM5bn
1991	Metallgesellschaft AG	Dynamit Nobel AG	Chemicals	100%	DM1.6bn
	Rheinbraun AG	Consolidation Coal Co (USA)	Coal mining	50%	DM1.45bn
	Krupp AG	Hoesch AG	Steel	Merger	
1992	Crédit Lyonnais (F)	Bank für Gemeinwirtschaft	Banking	100%	DM1.8bn
	Daimler-Benz AG	Fokker N.V. (NL)	Aviation	51%	DM750m
1993	Hoechst AG	Copley Pharmaceuticals Inc (USA)	Pharmaceuticals	51%	DM935m
	Karstadt AG	Hertie Waren- und Kaufhaus AG	Retailing	100%	DM1.5bn
	Heidelberger Zement AG	Cimentière CBR S.A. (B)	Concrete	42.6%	DM1.05bn
1994	RWE AG, Veba AG, Viag AG	Vereinigte Energiewerke AG	Utilities	100%	DM8bn
	Allianz AG	Vereinte Versicherung AG	Insurance	100%	DM3.6bn
	Allianz AG	Elvia Versicherung (CH)	Insurance	59.9%	DM1.8bn
	BMW AG	Rover Group (GB)	Automotive	80%	DM3.75bn
1995	Hoechst AG	Marion Merell Dow	Pharmaceuticals	72%	DM10bn
	BASF AG	The Boots Company (GB)	Pharmaceuticals	division	DM1.86bn
	Dresdner Bank AG	Kleinwort Benson (GB)	Banking	100%	DM2.2bn
	Deutsche Bank AG	ITT Commercial Finance (USA)	Export Financing	100%	DM3.6bn
1996	Fresenius AG	National Medical Care (USA)	Medical	51.9%	$2.3bn
	Robert Bosch GmbH	Allied Signal (USA)	Automotive	division	DM2.2bn
	Deutsche Telekom AG	Sprint Corp. (USA)	Telecoms	10%	$1.83bn
	SKW Trostberg AG	Master Builder Technologies (CH)	Chemicals	100%	DM1.6bn
	Henkel AG	Loctite Corp. (USA)	Chemicals	35%	DM1.9bn

Key: dark grey = German company buys foreign company;
light grey = foreign company buys German company;
white = German company buys German company.

Foreign investors in German companies have mainly been driven by two different motives:

- The high level of training among the workforce and the high technological level of the German *Mittelstand.*
- The attractiveness of the German market in itself and its central position in the European market which also can serve as a base for activity in the eastern European markets.

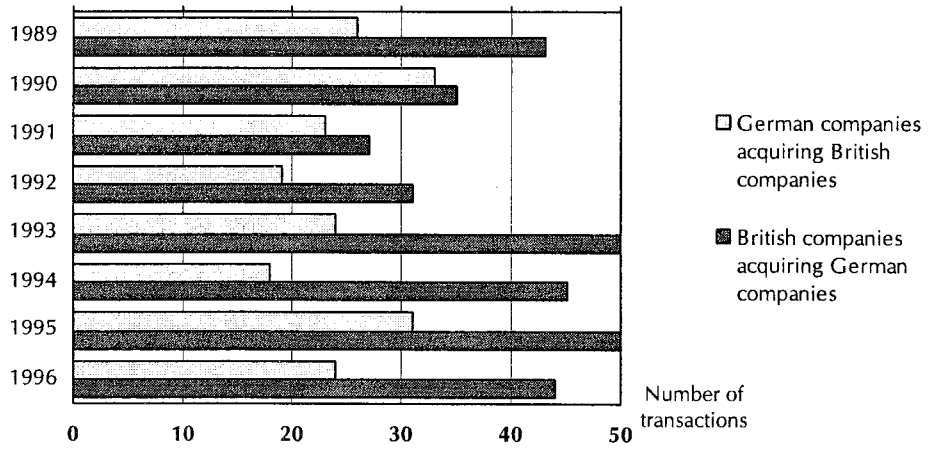
German companies that have been investing abroad have been pursuing a variety of different goals:

- The limited size of the home market has forced German companies to explore foreign markets; lately, they have increased their market development activities in emerging markets after many years spent focusing on industrialised countries.
- The acquisition of technology or know-how (e.g. biotechnology, investment banking).
- The shifting of labour-intensive production to low-income countries (e.g. textile industry).
- Striving for critical mass or a leading position in the world market (pharmaceuticals, automotive suppliers).

The case of British–German transactions

As mentioned above, British companies have consistently been acquiring more companies in Germany over the last eight years than vice versa (Figure 4.5). It also seems that their interest has grown in the last four years, whereas German activities across the Channel have been more stable.

Figure 4.5
British–German transactions since 1989



Source: M&A REVIEW Database.

A glance at the industries with the greatest level of activity (Figure 4.6) shows that a significant part of the transactions has been completed in the key manufacturing areas, led by the chemicals/pharmaceuticals and the electronics industry. In all industries except the automotive industry, British companies have been stronger buyers than their German counterparts.

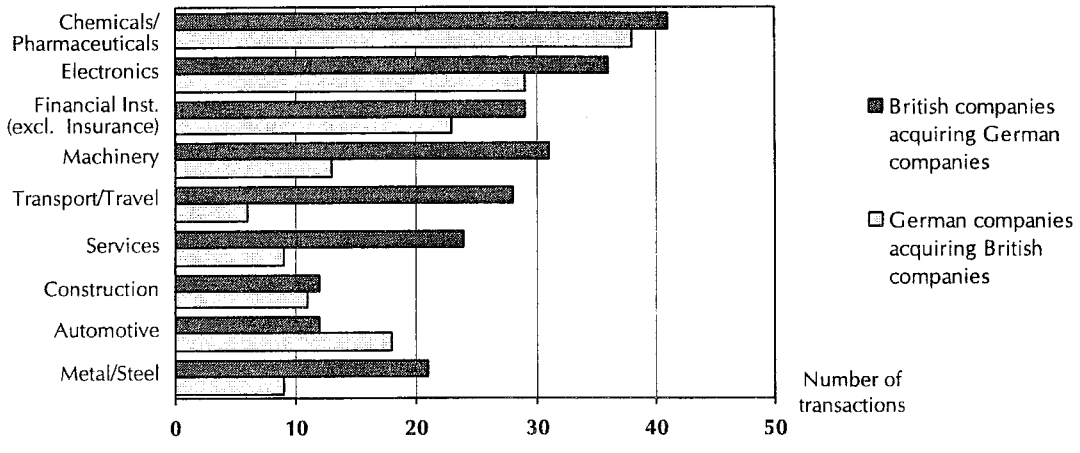
Although British investments in Germany have been outnumbering German investments in Britain, it seems that, in common with German M&A activity with respect to other countries, German investments in Britain have been more substantial. Some of the largest transactions are described briefly in the following section.

German–British transactions: success or failure?

One of the most spectacular German–British transactions has been the acquisition of Rover by BMW in 1994. BMW entered a joint venture in the aircraft engine business with Rolls-Royce in 1990 and therefore possessed a good level of understanding of British companies and their cultural background when it bought Rover. The Bavarian car manufacturer paid DM 2.1 billion for the DM 11 billion business and doubled its turnover. After the announcement, the deal was enthusiastically praised by analysts. Not only did BMW manage to close the deal without any assistance from investment banks, it also paid less than for the development of a new model in its 3-series and the purchase was judged to be a bargain, although Rover was in a difficult situation at that time.

However, the cultural differences between the two companies made the integration extremely difficult. Moreover, for a long time BMW did not have a restructuring plan for Rover and was undecided whether Rover should run a full product line or merely complement BMW's

Figure 4.6
British-German transactions by industry since 1989



Source: M&A REVIEW Database.

product line. Due to a change in accounting methods after the acquisition, Rover's earnings dropped from a profit of DM 40 million to a loss of DM 335 million, and its profits have been negative ever since. It is only now, after three years of opposition from Rover's management, that BMW is making substantial efforts to integrate the British car manufacturer.

But not only cultural differences make this a difficult task, it is further complicated by Rover's old product line and even more importantly by the different production technologies which are used. While Rover has been relying on batch processing (with 30 cars to a batch), as introduced by Honda, BMW assembles cars individually. The switch to BMW's approach, the modernisation of Rover's product line, and the reduction of the number of car platforms are important measures to increase Rover's competitiveness and make it a worthwile investment for BMW. BMW hopes to reach this goal within the next eight years and its chairman, Bernd Pischetsrieder, claims optimistically: 'There are no risks, there are only tasks to complete'. Considering the long list of unsuccessful international takeovers in the automotive industry, it will be interesting to revisit Pischetsrieder's remark in 2005.

The acquisition of Morgan Grenfell by Deutsche Bank in 1989 marked the beginning of the bank's drive for a place among the world's leading investment banks. On paper, Deutsche Bank at least partly reached this goal – recently the largest German private bank was ranked eighth in Euromoney's league-table of investment banks – although it is still lacking a strong base in the USA. Similarly to BMW's initially passive approach to the integration of Rover, Deutsche Bank did not come up with integration plans until only five years after the acquisition. A deep rivalry between the German and British investment bankers evolved, with victory finally going to the latter when responsibility for Deutsche Morgan Grenfell (DMG) was given to Michael Dobson. Jobs were shifted from Frankfurt to London, key positions were given to British investment bankers and many top international investment bankers were hired from rivals in order to increase DMG's competence in specific areas. These stars were offered extremely high salaries, further frustrating German employees who kept their old contracts. As a result of the reverse takeover and the emerging two-class society, many German investment bankers left DMG. As a result, the company has been left with a partly demotivated staff, and it is at least questionable whether in the long run it will be able to generate enough business to pay the salaries for its 'dream team' and still leave a satisfying profit.

In contrast to the cases of BMW and Deutsche Bank, Dresdner Bank already had a strategic plan in mind for an integrated investment banking business when it decided in 1995 to purchase the British merchant bank Kleinwort Benson. Takeover negotiations were still ongoing when Dresdner Bank began talking with key personnel at Kleinwort in order to keep them informed about the process and give them some idea of the bank's future. In order to avoid the same situation as at Deutsche Bank and because it had been accumulating competence in various areas (bonds, currencies and derivatives), Dresdner Bank decided to retain the responsibility for different major functions in Frankfurt. But the shifting of certain small departments such as the research subsidiary, Diri, to London created a feeling of insecurity among many German employees who feared similar developments to those at Deutsche Bank. But voices at Kleinwort continue to demand the relocation of all activities and responsibilities to London, and the bank's decision to divide its investment banking activities between the two centres recently led Simon Robertson, Kleinwort's chairman, to resign. Other employees had already left for the same reason or because they felt the bank was – unlike Deutsche Bank – lacking direction and motivation. Despite great efforts to avoid mistakes and make the merger work, Dresdner Bank is, like BMW and Deutsche Bank, far from sure that it will succeed.

In general, it is very difficult to assess the success of an acquisition and the factors that have led to a certain performance. However, many lists of dangers or critical success factors for cross-border transactions have been developed in the past of which a few have been illustrated in our small examples. The cases also show that the importance of these – mostly post-acquisition – issues should not be underestimated in spite of the comparatively small geographical and cultural distance in German-British mergers. Among the most important issues are:

- the avoidance or reduction of insecurity for the people involved;
- the identification of differences in perception and preferences;
- the ability to bridge the different cultures involved;
- the ability and willingness to accept compromises.

Concluding remarks and outlook for the future

Although Germany is lacking an M&A culture comparable to those of the USA or Great Britain, its market for corporate control has gone through a significant development during the last two decades in terms of its size and professionalism. From today's standpoint, we can identify a series of factors that are most likely to shape future activities in the German market for corporate control.

The actual trends of decentralisation and globalisation will certainly continue in the years to come and will be a challenge for German blue chips and, to a growing extent, for the companies of the *Mittelstand* which – due to their high level of specialisation – have a long tradition of dealing with international markets.

Numerous companies of the German *Mittelstand* which were founded after World War II are now in the third generation of ownership and face severe problems of succession which have to be solved within the next decade. It is likely that many of the companies which cannot solve this problem internally will have to bring in new investors, either through a management buy-out or with the help of an investment company, or sell the company off.

Another trend which is likely to give an impulse to the German M&A market is the increasing importance of services that are offered around the main product. Siemens has just recently taken a step in this direction with the acquisition of the industrial activities of Elektrowatt, which will strengthen its facility management business.

Finally, the market will see more activity stemming from industry deregulation. Presently, we are witnessing a lot of movement in the telecommunications industry which will be deregulated in 1998; and strong merger activities are expected to take place in the utilities sector, where the liberalisation process will begin in 1999.

As stated in the opening remarks of this paper, the German market for corporate control has great potential; the future will tell to what extent it is realised.

5 Restructuring Europe: an investor's view

Richard M. Young

A changing world demands restructuring

We feel it would be useful to begin this chapter by establishing some definitions. It is our impression that in its narrowest, and pejorative, sense the term 'restructuring' has become a euphemism for firing people, replacing 'downsizing' in this context. More broadly, we believe that an appropriate definition would include all strategies and actions that corporations have taken to increase the efficient use of capital and, more particularly, raise the returns on equity (ROE) capital. This view is in part coloured by our views on why this phenomenon – let us call it 'restructuring' for the moment without being too precise about the definition – has become important in the USA, Europe and Japan in the 1990s.

We start with the premise that corporate America did not wake up in the late 1980s and decide, on a whim, that they had to produce more profits for shareholders, work harder, fire people, narrow the focus of their businesses, buy their competitors, sell their businesses to their competitors, and all of the other things that fall under this rubric. While many analysts have pointed to the key issue as being the pressures from the 1980s environment in which leveraged and management buy-outs surged in the USA, we believe that these were merely the symptoms of rising opportunities for capital to enhance returns. These opportunities were being presented as a result of a variety of global trends which have forced this adjustment process which we call 'restructuring' on businesses in the developed world in the 1980s and 1990s.

Key among these trends, in our view, have been the integration of the emerging markets (including eastern Europe) into the global economy and the increasing importance of technological innovation in production and distribution. In our view, the first of these has raised the opportunity cost of investment in the developed world and is exerting continuing pressure to raise the returns to capital there. The second has, at least partially, supplied the means for responding to the increased return required in the face of the greater opportunity cost. Both trends are directly affecting industry and the economy at large in the developed world.

If we are correct in our assumptions regarding the underlying causal forces, then the key variable in monitoring the progress and prospects for restructuring in any company or market is likely to be the return on equity capital (ROE). The progress of the USA in the restructuring process, and the lack of progress in Germany so far, is reflected in Figure 5.1, which compares the ROE for the non-financial sectors of the equity markets in the two markets. US industry has seen its ROE rise from an average of just over 14% during the 1980s to an average of more than 17% during the 1990s.