

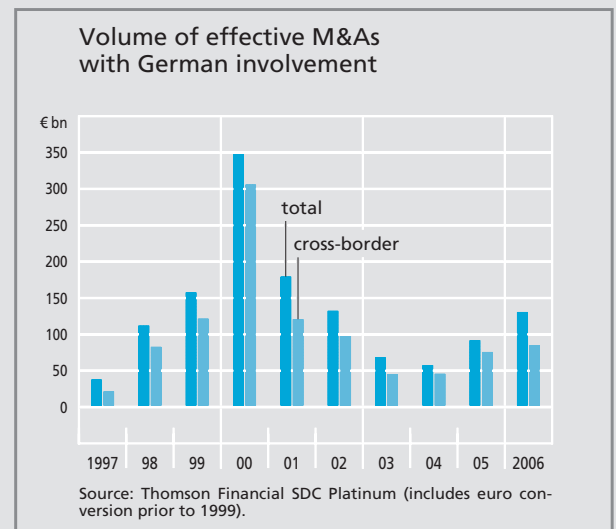
Mergers & acquisitions as an element of direct investment: development, sectors and financing

The Bundesbank collects data on cross-border direct investment on the basis of the Foreign Trade and Payments Act and internationally approved definitions.¹ In this context, new investments and liquidations of equity capital, reinvested earnings and credit transactions between affiliated enterprises are recorded and shown separately. New investment comprises long-term investment amounting to at least 10% of the capital or the voting rights. Thus, it includes not only cross-border mergers and acquisitions (M&As) between or of existing enterprises but also – which are currently indistinguishable – startups (greenfield investments).²

A separate analysis of cross-border M&As therefore still requires recourse to data from private providers. Since these providers pursue different goals when compiling the data and thus use different criteria and sources as a basis, some of their figures differ significantly from the official figures.^{3,4} Nevertheless, these statistics can also offer important additional information about enterprises' equity acquisitions and any risks resulting from their financing.

Last year, the effective mergers and acquisitions – calculated on the basis of figures from Thomson Financial SDC Platinum – increased worldwide by almost 30% to some €2.2 trillion. The German M&A market also recorded a further upturn in 2006. Thus, the value of completed transactions with German involvement rose by over 40% to €130 billion (see adjacent chart). In this case, almost three-quarters of the volume was accounted for by cross-border acquisitions.

Direct investment flows often develop analogously to trade flows.⁵ This is consistent with earlier observations that the substantial expansion of German foreign trade last year also gave the German economy a more prominent role in international M&A activity. Another factor may have been that domestic enterprises have internationally trans-



ferable competitive advantages – such as an attractive product range, a good market position or technical expertise – with which economies of scale could be realised by acquiring enterprises abroad.⁶ For example, German investors expanded their cross-border M&A involvement in 2006 by 14½% to €39 billion. Just over one-quarter each of German enterprises' total investment volume was directed at the materials sector abroad and the pharmaceuticals sector abroad. Both cases involved the two largest individual transactions.

Conversely, Germany was also an important target country for corporate acquisitions by foreign enterprises, even though the transaction volume in 2006 – following sharp rises in the previous two years – did not increase any further. Non-residents acquired participating interests in domestic enterprises worth €47½ billion. For the second year in a row, they showed a special interest in the German

1 See Deutsche Bundesbank, Statistical Supplement to the Monthly Report 3, Balance of payments statistics, pp 37 ff and Special Statistical Publication 10, International capital links, April 2006, pp 18 ff. — 2 In the case of first-time reports for 2005, the German stock statistics on direct investment differentiate between greenfield investment, purchases, mergers or acquisitions, and overshooting the reporting threshold. It is planned to publish the data at the end of April 2007. For the balance of payments statistics, too, there are plans to achieve a more detailed breakdown on the basis of an internationally harmonised set of rules. — 3 For example, Thomson Financial SDC Platinum evaluates publicly available information about M&As and also processes reports from the advising investment banks. This is based on an acquisition of a capital share of at least 5% or less in certain circumstances. Moreover,

capital increases are recorded, too. Problems also occur with regard to periodisation and the recorded transaction values. In the case of new investment, the balance of payments statistics focus on the actual transfer of ownership and include only that part of the transaction value which is actually exchanged between residents and non-residents. — 4 If only M&As that result in a capital share of at least 10% are considered – as in the balance of payments – domestic enterprises acquired foreign enterprises worth €39 billion in 2006, while non-resident proprietors accumulated participating interests in Germany worth €40½ billion, according to Thomson Financial SDC Platinum. The values published as new investment in the balance of payments were €91 billion and €25 billion, respectively. — 5 See K Ekholm, R Forslid and J Markusen, Export-Platform Foreign Direct Investment, NBER

real estate sector, which accounted for almost €19 billion in 2006.

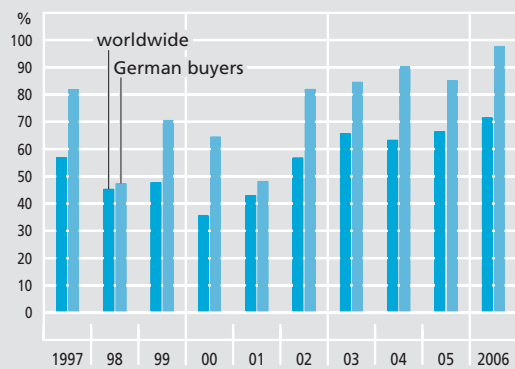
The financing structure of M&As has changed significantly over the past few years. Generally, there are two financing options for M&As: the exchange of shares or a cash offer. In the case of share swaps, the proprietors of the acquired enterprise are paid in shares of the investing enterprise, while in the case of a cash offer, they receive a cash payment. In the latter case, the acquiring enterprise can draw on available liquid funds or, as is often the case, it resorts – at least in part – to debt-financing by means of loans or the issuance of bonds. While during the “new economy” boom (in the years 1998 to 2001) the exchange of shares was the predominant financing method worldwide, accounting for 57%, most recently 72% of the financing volume was accounted for by cash offers. One reason for this change may be that, following the slump in share prices, shares have become less attractive as a “means of payment” for the shareholders of acquired enterprises. Moreover, the rising profitability of enterprises in recent years is likely to have facilitated the accumulation of liquid funds. In addition, the debt financing of acquisitions has become especially attractive of late owing to the low interest rates in the capital markets. It is noteworthy that, over the past ten years, the average share of cash transactions in acquisitions by German enterprises was 20 percentage points higher than the worldwide average.⁷

In macroeconomic terms, M&As can help to improve the allocation of capital. Welfare gains can be expected from the realisation of cost advantages, more efficient management or the exploitation of economies of scale. However, debt-financed acquisitions, in particular leveraged buy-outs (LBOs), ie acquisitions of established enterprises or parts of them in which a significant part of the acquisition cost is

Working Paper, No 9517, 2003 as well as S Herrmann and A Jochem, Trade balances of central and east European EU member states and the role of foreign direct investment, Deutsche Bundesbank Discussion Paper, Series 1, No 41/2005. — 6 J H Dunning (1988), The Eclectic Paradigm of International Production: A Restatement and Some Possible Extensions. *Journal of International Business Studies* 19(1), pp 1-31. Technological aspects seem to be especially important for cross-border activities. See R Frey and K Hussinger, The role of technology in M&As: a firm-level comparison of cross-border and domestic deals, Deutsche Bundesbank Discussion Paper, Series 1, No 45/2006. — 7 The large share of cash transactions of German enterprises may also reflect legal constraints on share swapping, eg the problem of the exclusion

paid for using borrowed funds, can also pose problems to financial stability, especially as there has been a sharp rise in the financing volume in this area in particular.⁸ The fact that the average rating of LBO enterprises has tended to deteriorate – with possible negative implications for the previous creditors – should be viewed critically. Although the sharp rise in the ratio of debt to operating profit observed in the recent past can be seen as an attempt by investors to increase their return on equity in times of low interest rates, it must not be forgotten that this could make enterprises increasingly vulnerable in the event of rising interest rates, for example. Even if banks pass on the loans relating to an LBO to other creditors, they may still incur risks because, as underwriters, they may be exposed to a market shift during the holding period. They may also be vulnerable to an indirect risk if the exposure arising from LBOs is assumed by hedge funds which themselves are indebted to the banks.⁹

Share of cash financing in the effective transaction volume



Source: Thomson Financial SDC Platinum and Bundesbank calculations.

of existing shareholders from participating in capital increases and a possible complaint from existing shareholders about the dilution of the share value. Moreover, German enterprises are allowed to hold only 10% of their own shares. See *Börsen-Zeitung*, Deutsche Konzerne bei M&A im Nachteil, 19 January 2007, p 10. — 8 The total amount of worldwide M&As completed in 2006 exceeded €2.2 trillion, €315 billion (14½%) of which are classified as leveraged buy-out transactions according to figures provided by Thomson Financial SDC Platinum. For acquisitions with German involvement, the share was somewhat lower at 9½%. — 9 See also Deutsche Bundesbank, Risks arising from the financing of leveraged buy-out transactions (LBOs), *Financial Stability Review*, November 2006, pp 44-45.