Institute of Economic Affairs

# Shareholders, not politicians, should decide on takeovers

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**Summary**

- **The ongoing controversy over Melrose's purchase of engineering company GKN illustrates many common misunderstandings about how free markets can work to the benefit of all**.
- Shareholders, not politicians, should decide how to run their businesses, including whether a new management team could do better. There is only a limited set of circumstances where it might be right for the government to intervene – such as on grounds of national security, or to mitigate the risks of taxpayer bailouts. But these concerns are usually exaggerated.
- Some have also argued that decisions on takeovers should not be left to 'vulture funds' or 'asset strippers' who, they claim, are only looking to make a quick profit with no regard for the wider implications. This analysis is misleading (as well as the language), because one sure way to maximise shareholder value in any company is to improve its long-term performance.
- The interests of investors should therefore already be aligned with those of others who also want a company to thrive, including employees and customers. This alignment can be strengthened further via market mechanisms, if necessary, such as financial packages that reward managers for long-term results.
- This is far preferable to a more protectionist approach, where change is resisted, competitive pressures are weakened, and shareholders rights are undermined. Indeed, playing politics with companies might actually be the worst form of 'short-termism'.

## Introduction

On 29th March, turnaround specialist Melrose won a narrow victory in its bid to purchase the engineering firm GKN, gaining the support of 52% of shareholders. The offer is due to become 'unconditional' on 19th April, which means it will be a done deal as far as the two companies are concerned. However, the government has already intervened to impose its own conditions on the takeover and is still under pressure to go a lot further.

At first sight, this is not obviously a matter of public policy. The owners of a global engineering company have decided that it should be run by a British firm that specialises in improving the performance of manufacturing businesses, rather than by the current management. I have no view on whether they were right to do so (the 52%/48% split suggests it was a close call). But it was their decision, and that is how it should be.

Nonetheless, some politicians and commentators are still demanding that the government block the takeover, or at least that Melrose should be required to make additional commitments (notably on jobs and future divestment plans). The Daily Mail, in particular, has mounted a vocal campaign to 'save GKN'.

It is therefore worth exploring the arguments made in this case and considering their wider relevance, as well as addressing the issue of shareholder rights more generally.

**Is GKN a special case?**

Objections to the takeover can be divided into three types: that GKN is a special case requiring extra protection from the government; that Melrose is not a suitable purchaser; and that the decision has been taken by investors with little interest in the long-term implications.

Some of these objections are, frankly, no more than PR guff. For example, a lot has been made of GKN's long British history, with honourable mentions for the company's role in producing the cannonballs used at Waterloo and building the Spitfires that helped defeat the Luftwaffe. In reality, only around 10% of GKN's employees now work in the UK, and the company describes itself as a global business. To the extent that nationality is ever relevant, Melrose may actually have the better claim to be a 'British' company.

A more serious point is that GKN participates in activities which might be of special importance to the economy and security of the UK, including high-tech manufacturing businesses in the aerospace and automobile sectors. As it happens, GKN is only a small player in the defence industry (it is not one of the MoD's top 50 suppliers), but size may not be everything.

However, even if there is something special about what GKN does, there is still the question of why Melrose might not be a suitable purchaser. A change in ownership, in itself, does not undermine GKN's potential to contribute to the wider economy, or threaten jobs and investment. And it is not as if GKN is about to be sold to, say, Russia or China, or that the government couldn't block a future sale on these grounds if they ever arose.

**What's wrong with Melrose?**

Critics of Melrose itself have focused on what they see as risks in its business model, including the company's strategy of selling companies on within a few years (fueling accusations of 'short-termism'), and its use of borrowing to finance takeovers.

Initially, opponents raised fears that the takeover would saddle GKN with excessive debt and undermine its pension fund, potentially requiring a taxpayer bailout. This is perhaps one area where intervention could be justified. It does not seem unreasonable for a potential acquirer to be asked to seek approval from the pension regulator when third parties might have to pick up the bill for failure (an example, perhaps, of 'moral hazard'). But Melrose has now addressed these concerns, notably with commitments to top up GKN's pension fund.

However, this has quickly broadened into a debate where much of the language is unhelpful. Even the term 'hostile takeover' can create the wrong impression. It simply means a purchase that is opposed by the current management and therefore relies on the potential acquirer appealing directly to the shareholders. The incumbent team might resist a takeover for many reasons – some good, some bad.

In this case, the acquirer has also been described as an 'asset stripper'. For example, the assistant secretary of the Unite trade union, Steve Turner, has said of Melrose, 'they take over businesses, they break businesses up, they compartmentalise them and then flog them off to the highest bidder in order to maximise shareholder value'.

This quotation is revealing. For a start, it doesn't show much understanding of the circumstances here. GKN had already agreed to sell its automotive business to a foreign competitor, and was planning to sell its powder metallurgy business, both moves opposed by Melrose. In any event, the existing GKN management team presumably intended to 'maximise shareholder value' too.

But the trade union's comments (echoed by other left-leaning politicians) also imply that the objective of making money for shareholders is somehow wrong. In fact, shares are a claim on the future profits of a company and their value will rise or fall depending on how the markets expect the company to perform. A strategy that is expected to boost performance over the longer term will therefore benefit shareholders straightaway.

Correspondingly, even if a purchaser did plan to sell off part of business up in order to get a higher price, the fact that a company might be worth more in parts than as a single entity would imply that breaking it up is the right thing to do. Turning the point around, if there are real economic advantages in keeping the businesses together, how would breaking them up 'maximise shareholder value'?

Indeed, what is the alternative to 'maximising shareholder value'? 'The destruction of shareholder value'? This may well be the result if political objectives are put first, harming not just shareholders but all those with a stake in the success of the company.

**Short-termism**

This brings us to the third type of objection – that the takeover has been decided by shareholders – including 'rapacious hedge funds' – who just want to make a quick profit regardless of the long-term implications for the business, let alone for the wider economy. This argument doesn't stack up either.

Again, let's start with the facts of this case. GKN's shareholders were primarily what might be called 'long-term investors', including some of the best-known names in UK fund management

Some of these opposed the Melrose bid, but many of them voted in favour. Indeed, a large proportion were shareholders in both GKN and Melrose to begin with. The overlap is large enough that it is debatable how far 'ownership' has changed at all.

There are two further reasons to be take a more relaxed view. First, as is common in these sorts of takeover, existing GKN shareholders are being offered a mix of cash and shares in Melrose. They will therefore want Melrose to make a success of running GKN, even if they were not invested in Melrose to begin with.

Second, even if a GKN shareholder did want to exit completely (selling their new Melrose shares too), the next purchaser will presumably also want to see GKN thrive in order to realise a decent return on their investment. It seems odd to complain about 'rapacious hedge funds' making a quick profit if they do so by selling back to 'long-term investors', especially as they had presumably bought from 'long-term investors' who had lost faith in GKN's management.

**What should government do?**

Nonetheless, the government has responded to the political storm by placing additional conditions on the takeover. Melrose has been obliged to make specific commitments on R&D, training, employment rights, and pensions. It has also promised to maintain a UK HQ and not to sell GKN's Aerospace Division before 2023, unless the government agrees otherwise.

In themselves, these conditions are not too onerous. They are the sort of things that a well-managed business would do anyway, and the five-year horizon is consistent with the usual timescale under which companies like Melrose operate. The government could already block a future sale at any time. In short, these conditions are almost certainly unnecessary, but should be more than enough to address any remaining concerns.

Going any further, however, would surely be counter-productive. The real 'short-termism' here is the political pressure to protect companies from potentially unsettling changes, even when they could improve the performance of the business. The threat of takeover helps keep management on their toes.

Global investors also need to know that they can buy and sell at will if they are going to choose to put money to work in the UK. Owners of any asset – including corporate equities – should be free to dispose of them as they see fit. Otherwise, an increased political risk premium will make borrowing more expensive and deter investment.

To be clear, 'short-termism' may well be a problem in some companies, and financial markets do not always reward long-term investment correctly. No-one is claiming that markets work perfectly every time. But this alone does not justify government intervention. Politicians are at least as likely to be swayed by short-term considerations, such as narrow constituency interests or the desire for a favourable press. And they are almost certainly worse judges of economic realities than the shareholders who actually own a business.