

**PROSPECTIVE MERGER ACTIVITY
IN CANADA**

Prepared By:
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Prepared For:
Economics and International
Affairs Branch, Bureau of
Competition Policy, Consumer
and Corporate Affairs Canada

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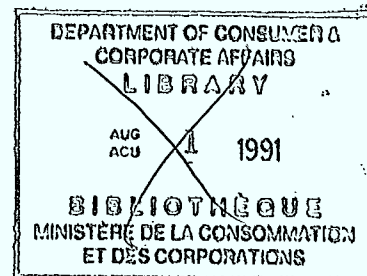
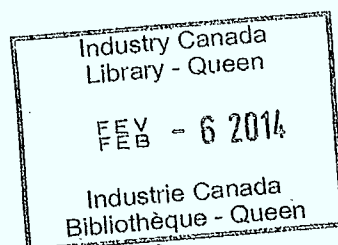
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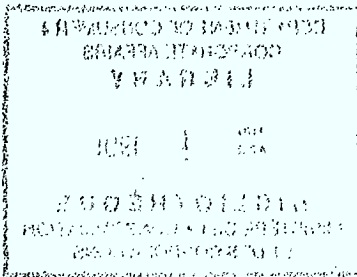


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PROSPECTIVE MERGER ACTIVITY IN CANADA

Summary and Conclusions

1. The near-term economic conditions in Canada suggest a decline in business activity; the number of mergers and acquisitions might therefore be expected to decline. Sluggish growth, high interest rates and the current level of the Canadian dollar are likely to persist for the next year.
2. However, trends and developments internationally which have been the source for much of the recent merger activity are structural in nature, and show no sign of abating. Trading blocks in North America, Europe, and the Pacific Rim, in conjunction with the globalization of production suggest continuing re-organization of industries as corporations re-structure their activities and focus on core businesses. These factors suggest a continuation of the high level of merger activity.
3. Among the M&A professionals, views on prospective levels of merger activity are split. Some of the large investment dealers are quite pessimistic, citing near-term economic considerations, the apparent lack of interest by European and Japanese investors to acquire Canadian businesses, and the Free Trade Agreement's apparent disincentive for Americans to invest in Canada.
4. A more positive view is offered by M&A professionals whose business is less dominated by transactions with publicly-listed corporations. These "middle market" professionals expect continuing strong merger activity due to policies enhancing competition at home and abroad, re-structuring and returning to "core businesses" by the large corporations, the lifting of the Investment Canada review threshold for American investors under the Free Trade Agreement, the decline in equity markets and price/earnings multiples, and the expected decline in interest rates and the Canadian dollar.
5. A review of the literature on the determinants of merger activity in the U.S. and Canada reveals no satisfying explanation for its wave-like feature. The only variable consistently associated with merger levels is stock market activity; industrial activity seems unrelated.

6. The problems with such research include lack of a comprehensive data base. Government agencies and information services record only those transactions above a certain cut off level. Moreover, over time, more mergers are included in the data base, not because more mergers are actually taking place, but because inflation has raised the values of transactions over the cut off point. Successful identification of the determinants of merger levels with this type of data is necessarily difficult.
7. M&A professionals have identified sixteen industries and sectors where merger activity is likely. The emphasis is on manufacturing and services, and clearly away from natural resources. In the financial sector, mergers among the large banks and acquisitions of property and casualty insurers are expected.
8. There is a generally-held view that transactions will be smaller on average than in the recent past, and that the major sources of foreign interest in acquiring Canadian companies will be the U.S. and the U.K.. Other European and Japanese investors are seen as preoccupied with regional developments.
9. The conglomerate, or financially-motivated, acquisition is not expected to occur in any significant number. Rather, the clear focus will be horizontal mergers, including product and market extension transactions.
10. The apparent dearth of vertical mergers may reflect a mis-interpretation by M&A professionals as to the reasons for these transactions. While vertical mergers will often be non-problematic from a competition policy perspective, in industries with dominant firms, integration by the leading firm may take place in order to place smaller rivals at a strategic disadvantage.
11. There appears to be an interest in acquiring Canadian firms with some specialized "soft assets", such as patents, expertise, distribution capabilities, etc. In such an environment, mergers with strategic goals (eg. to erect entry barriers) may become prominent. In general, however, the relevance of the literature on strategic business behaviour for competition policy is unclear.
12. There is at least one Canadian research joint venture and more may be formed, perhaps with government support. Whether these ventures enhance or substantially reduce competition is not clear. The literature on efficiencies in joint ventures and antitrust policy toward high technology industries may assist in developing the analytical framework to evaluate proposed consortium arrangements.

13. Under the Free Trade Agreement, North America will be frequently proposed as the relevant geographic market by merging parties and their advisers. One offshoot of this is increasing acquisition of U.S. companies by Canadians, and the question this raises about elimination of a potential competitor in the Canadian market. Competition policy enforcers may wish to examine such mergers from a Canadian perspective, even though they involve a foreign target.

Given continuing foreign interest generally, acquisitions by, and joint ventures with, foreigners in Canada raise competition policy issues. As the foreign business would be unlikely to enter the Canadian market in competition with its local subsidiary, the acquisition may lessen potential competition in the Canadian market. Accordingly, if "de novo" entry was a realistic alternative, the acquisition will remove a restraining influence on the pricing behaviour of actual domestic participants.

14. Acquisitions of commercial entities by government-owned or controlled businesses and by regulated companies raise the possibilities of extension of monopoly power and cross-subsidization.
15. As Canadian competition policy places less importance on market share than does the U.S., indexes that focus on the ability of the firm to raise price over marginal cost may be relevant. The "aggregate Lerner index" proposed by Ordover, Sykes and Willig has the additional benefit of focussing on rivalry and is calculated with reference to the Herfindahl index and the elasticity of demand.
16. The literature on the basic confusion that exists in U.S. merger policy between (a) minimizing inefficiencies, and (b) preventing income transfers through price increases, may be relevant for Canadian approaches, given the statutory availability of the efficiency defense. If preventing price increases is the main goal, efficiencies should be demonstrated to be large enough to prevent the price increase, not merely to exceed the inefficiencies induced by the merger. By requiring that benefits be passed on to consumers, Canadian competition policy would resolve this dilemma in favour of a "price standard".

PROSPECTIVE MERGER ACTIVITY IN CANADA

This study is prepared for the Bureau of Competition Policy under the contract dated September 24, 1990 as amended. It assesses the likely course of merger and acquisition activity in Canada over the period 1991-96. Its goal is to forecast the level of such activity and the key features thereof in light of the competition policy concerns of the Bureau and related issues of interest to other agencies.

Goals of the Study

- (1) to describe/estimate the level of merger activity likely to prevail in Canada from 1991-96 based on the expected economic environment;
- (2) to identify the major factors that are likely to affect merger activity, with particular emphasis on the competition and related issues to be posed by merger activity over that period;
- (3) to offer proposals regarding where the Bureau's economic support activities with respect to merger review should be directed during this period.

Methodology

Further to the terms of reference for this study, the research approach contains primary and secondary components. Interviews were held with knowledgeable professionals in the mergers and acquisitions business, including representatives of major investment dealers, merchant banks, and financial and legal advisers.

Reviews of the relevant research literature were also undertaken and several academic economists were consulted as well.

Organization of the Report

The report is organized as follows. Chapter 1 notes the major domestic and international factors driving economic activity, focussing particularly on globalization and its implications for Canada. Chapter 2 reports the perspectives of the M&A community regarding the expected volume of merger activity and the factors deemed significant to the professionals. A review of the research on the determinants of merger activity in Canada and the United States is included.

The main features of merger activity are presented in Chapter 3, with particular regard to industries and sectors likely to be affected, the size of transactions, extent of foreign involvement, and the impact of market structure.

Competition policy issues that arise from this activity are highlighted. Chapter 4 focuses particularly on the financial sector.

In the final chapter, a number of enforcement issues are briefly identified based on the preceding analyses. They are:

- (1) measures of concentration,
- (2) efficiency versus price-setting as policy goals,
- (3) the relevance of strategic behaviour for competition policy,
- (4) enforcement regarding high-technology industries,
- (5) efficiencies of joint ventures, and
- (6) the relationship of competition policy to foreign direct investment.

These areas may be relevant in the preparation of merger guidelines as well as for subsequent enforcement, and may merit further consideration.

CHAPTER 1: TRENDS AND MAJOR FACTORS IN ECONOMIC ACTIVITY

The level and type of merger activity that Canada will experience over the period 1991-96 will reflect both global trends and domestic economic conditions and policies. Broadly speaking, the global environment appears to be emphasizing those factors that contribute to a continued high level of merger activity, while the domestic context appears to suggest a reduced level.

1.1 The Domestic Economic Outlook

Taken on its own, Canada's medium-term economic prospects suggest a declining market for mergers and acquisitions. The merger boom of the past few years has clearly been correlated with high levels of economic activity, rapid increases in stock market valuations of corporate equities, and low real interest rates in comparison with the early 1980's.

However, the near-term economic outlook as characterized by the annual report of the Economic Council of Canada (1990) is one of recession, the major questions being the length and severity of the downturn. The next year will be characterized, at best, by growth of 1% in real GDP, along with rising unemployment exceeding 10%, and lower, but still high inflation and interest rates; the prime rate charged by Canadian banks could decline from the January level of 13.75% to an average of 10% or less for 1991. In the event of a recession, output could well contract through the middle of 1991, with only modest reductions in inflation and interest rates during that period.

The key features of the immediate outlook are the recession in the United States, which affects Canadian final demand through reduced export growth, the imposition of the Goods and Services Tax, volatile world oil prices due to the war in the Persian Gulf and problems after the war, and the continued stance of monetary authorities in both countries against inflation. The spread between Canadian and U.S. short-term interest rates may narrow modestly allowing the Canadian dollar to decline somewhat against the U.S. unit, to US \$0.84-0.85 by mid-1991.

The period 1992-96 should see a return to growth in GDP in the range of 3-4% per annum, with inflation rates of 4-4.5%. Unemployment may hardly decline due to the higher participation rate and labour force growth that can be expected. The Canadian dollar should decline to the level of US \$0.80, as the central bank eases monetary policy in the face of evidence of declining inflationary numbers.

1.2 Global Trends

The medium-term outlook is also influenced by a number of structural changes in the global economy that are expected to continue. Chief among these are the trend towards intra-regional trade in North America, Europe and the Asia-Pacific regions, the global organization of an increasing number of industries, and the continued spread of market-oriented policies by governments.

(a) Stronger Trading Blocks:

The post-war expansion of world trade has led to an increasingly interdependent system of export flows. An analysis of export shares over the past 20 years shows the gradual evolution of three distinct trading regions. Data from the Economic Council of Canada demonstrate that more than 40% of the exports of Canada, United States, and Mexico are now sold within North America and analogously for Western European exports. In the Asia Pacific region, (including Japan, South Korea, Taiwan, Hong Kong, the Philippines, Malaysia, Singapore, Thailand, and Indonesia), more than 30% of trade is intra-regional. See Exhibit 1.1.

Moreover, the share of world exports originating in Canada and the United States fell from 1971 to 1987, while the share of the Asia Pacific region rose. Western Europe's share of world exports appears to have remained unchanged. See Exhibit 1.2. The dramatic expansion of world exports by the Asia Pacific region, and the likely increase by the members of the European Economic Community clearly suggest that North America is no longer the locomotive of world economic growth.

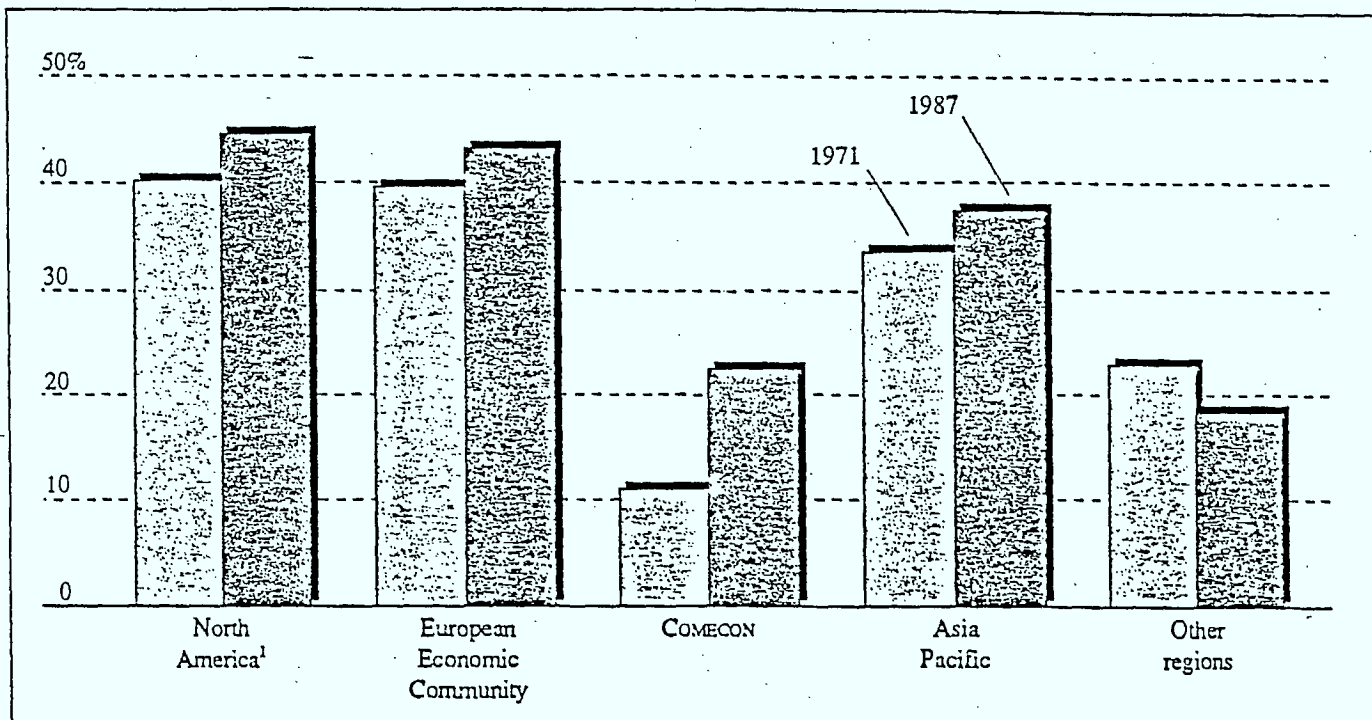
(b) Europe's "Single Market"

The development of the Western European trading block will be particularly enhanced with the movement toward the "single market" envisaged under the Single European Act of 1987 respecting the members of the European Economic Community. Tariffs on intra-Community trade have already been eliminated. The Act provides for numerous reforms to be in place by the end of 1992 that eliminate virtually all non-tariff barriers including physical, technical and fiscal barriers to trade, the harmonization of technical standards, and the free movement of labour within the Community.

The European Commission calculates that the removal of customs formalities and restrictions on government procurement would each add about 0.5% to Community GDP. Liberalization of financial services would add 1.5%, while a further boost of as much as 2.0% of GDP would be generated by the second and third stage effects as companies achieve scale economies and reduce costs. The total increase to annual GDP could therefore be some 4.5% above what otherwise might have been.

EXHIBIT 1.1

Intraregional Trade, 1971 and 1987

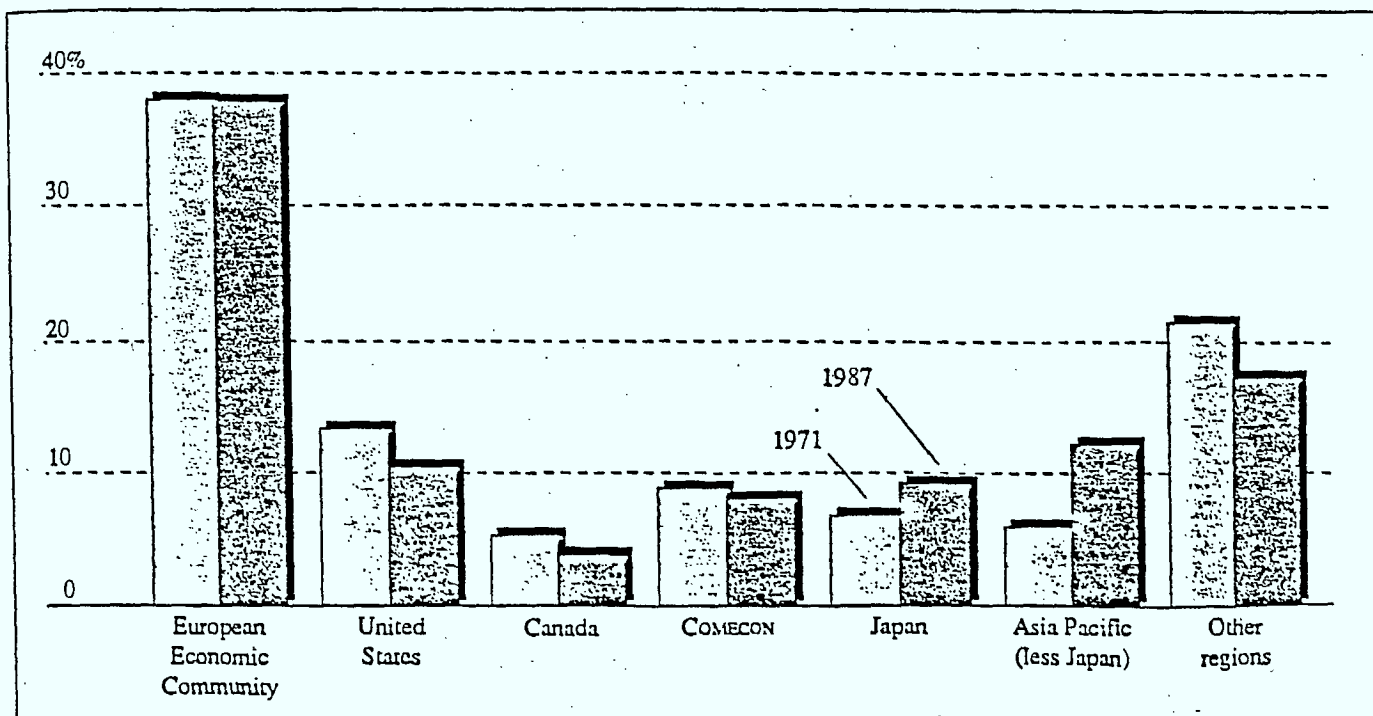


¹ Including Mexico.

SOURCE Based on data from Statistics Canada's World Trade Database.

EXHIBIT 1.2

Regional Shares of World Exports,¹ 1971 and 1987



The efficiencies that are the result of this type of economic integration require significant industrial re-structuring, and imply substantial investment in plant and equipment. A high level of merger and acquisition activity within Europe has already been observed, and is expected to continue as firms attempt to position themselves for the market as a whole.

(c) Japan

On a cyclical basis, the Japanese economy appears to be slowing down. Concerns about inflation, interest rate increases, sharp declines in the current account surplus, and a 39% decline in the stock market from its peak are making business financing more difficult. Indicators of the slowdown are the reduction in bank capital and lending, and a number of dispositions of major investments in the U.S. by Japanese investors.

However, Japan continues to experience large increases in its deficit on capital account. The long-term capital account deficit was US \$4.84 billion, up sharply from US \$3.63 billion a year earlier. It would appear that Japanese foreign direct investment continues to be strong. Whether Canada will receive an increasing share of Japanese foreign direct investment is an important question in the global context.

Rugman (1990) notes that Japanese foreign direct investment is concentrated in resource extraction and in the wholesale-distribution of Japanese products across Canada. There is some Japanese foreign direct investment in manufacturing, especially in areas where U.S. political pressure has been applied to displace Japanese exports, eg. in the auto and auto parts industries.

Nonetheless, Japan is unlikely to increase its foreign direct investment in Canada unless the United States becomes more protectionist and begins to discourage Japanese foreign direct investment. There are significant advantages under the Free Trade Agreement to investing in Canada, including improved access to the U.S. market, the unique dispute settlement mechanisms, and guaranteed national treatment and rights of establishment for Japanese-owned, Canadian businesses as regards the U.S.

As Rugman points out, on the basis of the Free Trade Agreement alone, Japanese foreign direct investment in Canada should increase rapidly in the near future, by a broader range of Japanese firms and including more manufacturing activity. He notes, however, there is a clear Japanese preference in favour of U.S. operations over Canadian locations, reflecting perhaps a failure to appreciate the benefits of the Free Trade Agreement and also perhaps come concern about political stability in Canada especially in the wake of continuing constitutional difficulties.

It is also true that the Free Trade Agreement is being implemented over a ten-year period, and that questions relating to subsidies and anti-dumping have not been settled. Accordingly, it may be premature to firmly conclude that the expected increase in Japanese investment may not eventuate.

(d) Developing Attitudes to Foreign Investment in the U.S.

This apparent preference for the U.S. over Canada may be reduced significantly as a result of efforts by the U.S. Congress to tighten restrictions on foreign investment in the United States. In 1989, foreign direct investment in the United States grew by 22% to \$400.8 billion. Growing concern over this trend has manifested itself in recent public opinion polls which suggest that a majority of U.S. voters would like to see restrictions on foreign investment. The legislation has the support of Democrats, organized labour, many public interest groups and a large number of citizens concerned about foreign takeovers in America.

Congressional efforts in this direction include:¹

- legislation sponsored by Rep. Gephardt that would strengthen the ability of the Internal Revenue Service to go after the U.S. profits of foreign-owned companies;
- the introduction of the Bryant-Harkin "Foreign Ownership Disclosure Act" that would require disclosure of sensitive proprietary and confidential business information;
- the introduction of the Sharp-Johnson-Hamilton "Foreign Investment Policy Improvements Act";
- the introduction of the Lent "Foreign Investment Analysts Act", which creates no new reporting or disclosure burdens for foreign-owned companies; administration support for this measure signals concern about the problem as a political issue, if nothing else;
- efforts by Rep. Walgren to strengthen U.S. anti-foreign takeover law and to require that foreign acquisitions of important U.S. technologies be subjected to rigorous investigation.

These efforts are unlikely to be approved in the current Congressional session, and the Administration does not support the most extreme legislative attempts. However, the situation may change in the new year following Congressional elections this fall.

In the absence of changes for the worse in the U.S., however, Canada will not likely overcome the preference of Japanese managers to conduct foreign direct investment in the United States in the next few years. Exacerbating this weakness is the Japanese developing interest in Europe. The Mitsubishi purchase of control of Rockefeller Center, and moves by members of its Bkeiretsu to acquire Pittsburgh-based Aristech Chemical Corp. and to form a joint venture with Daimler-Benz AG of West Germany are indicative of the prevailing direction of Japanese activities abroad.

(e) Globalization of Industry

A key feature of the global economic environment is the trend toward the organization of all aspects of production and marketing within firms on a global basis. Within one firm, product research, manufacturing, assembly and marketing are carried out in several countries simultaneously with a high degree of intra-firm exports.

This organizational form is distinguished from its predecessor, the multinational firm serving local markets through autonomous subsidiaries; such firms compete essentially on a country-by-country basis. In a globalized industry, the firm must compete on a worldwide, coordinated basis or face strategic disadvantages.

The advantages of global organization include traditional comparative advantage, economies of scale in production, global experience sharing, purchasing and product differentiation, among others. On the basis of such advantages, it appears that an increasing number of industries have become globalized since the 1970's. Unpublished research from the Wharton School has identified 136 globalized industries including services, low-technology products, and research-intensive sectors.²

As companies increasingly organize along global lines, foreign acquisitions of Canadian businesses with particular attributes and skills (eg. patents, management, North American distribution) will be prominent, particularly in manufacturing.

(f) Government Policies

Porter (1980) suggests that globalization is promoted by reduced government constraints (eg. removal of quotas and differences in technical standards, plus tariff reductions) and access to the U.S. market due to its large size.

Developments in Europe suggest that access to the "single market" will also stimulate globalization, perhaps abetted by rising U.S. protectionism as indicated by its adoption of the "Structural Impediments Initiative".

National policies to promote international trade under the GATT have been successful in promoting merchandise trade and have been partly responsible for the globalization of production of goods. The Uruguay Round of the GATT is dealing with trade in services, trade-related investment, and trade in (and protection of) intellectual property. If ultimately successful, these negotiations should enhance the trends toward global organization of industries. It now appears that the failure to reach agreement on agricultural issues in December, 1990 will delay further negotiations.

1.3 Implications

Canada's experience regarding mergers and acquisitions in recent years reflects the global forces noted above. While the country may experience an economic slowdown or recession in the coming year, a significant reduction in merger activity is unlikely; the forces leading to it are global in nature and will not abate.

A recent report by Investment Canada on the business implications of globalization goes even further. It argues that if scale and market share are becoming important components in a competitive strategy, competition policies may need to be reviewed to ensure they do not prevent needed rationalization while continuing to safeguard against anti-competitive behaviour.³

CHAPTER 2: IMPLICATIONS FOR LEVEL OF MERGER ACTIVITY IN CANADA

The domestic and international background discussed in the preceding chapter has implications for the level of merger activity that can be expected in Canada over the next few years. However, on the basis of interviews with knowledgeable professionals in the merger and acquisition field, opinion appears to be sharply divided on whether such activity will continue at recently high levels or decrease substantially.

To reach a conclusion on the likely course of merger activity in Canada, the views of the financial community have been supplemented by a review of the research literature on the determinants of mergers in Canada and the United States. The second part of this chapter summarizes the major conclusions of this research.

Taking into account the clientele of the various merger professionals, the divergence in their perspectives can be explained and a conclusion on the likely course of merger activity can be drawn with reasonable confidence. The third part of this chapter discusses this material.

2.1 Background for the Interviews

The views and expectations of the mergers and acquisitions community in Toronto have been solicited as part of the attempt to forecast the level of merger activity in Canada over the next few years. It was felt that their views would be informed both by their economic outlook and their contacts with clients that would give them some insight both as to the level of activity and the salient reasons for that activity.

In order to obtain a broad overview of the "M&A market", interviews were held with senior M&A officers in the large investment dealers and banks, the corporate finance groups of accounting firms, legal counsel active in merger review under the Competition Act, and specialized firms involved in strategic planning, large and middle market mergers and related financial advisory services. In view of the significance of the global economy and Canada's interest in foreign investment, firms with foreign links were consciously sought out.

All interviews were held between September 26 and October 19, 1990. The individuals interviewed and their affiliations are indicated in Appendix A. All participants were assured that no views would be attributed to them or their firms.

2.2 Expectations of the M&A Community: The Negative View

There is a diversity of views among the M&A professionals consulted on the level of expected merger activity. A certain pessimism is prevalent among the large securities dealers and specialized M&A advisory firms that deal in large transactions.

This pessimism expresses itself in both domestic and international considerations. Domestic economic considerations are frequently cited, with dealers appearing to be more pessimistic than, for example, the Economic Council of Canada forecast noted in Chapter 1. A severe recession is widely expected, and based on this perspective this would restrain domestic mergers and acquisitions by Canadian investors for its duration. Monetary policy, high interest rates, and the resulting high level of the Canadian dollar in U.S. terms, as compared with Canada's trading partners, further suggest to the large dealers that foreign interest in acquiring Canadian companies will diminish.

Other reasons cited for a declining M&A environment are as follows:

- The large Canadian companies are unable to expand domestically due to the small market, stronger Competition Act enforcement, and the pressures of globalization and the Free Trade Agreement; accordingly, larger companies are looking to invest abroad.
- Foreigners face regulatory and legal hurdles in acquiring Canadian companies in "sensitive sectors" such as communications, cable television, banking and energy, as one respondent stated; "Investment Canada is stopping foreign acquisitions in the oil and gas sector".⁴
- As a result of the movement toward the "Single Market" in 1992, American, Japanese and European investors are focussing on the member states of the European Economic Community.
- Under the Free Trade Agreement, U.S. companies have less reason to establish Canadian operations than previously.
- Limited interest is observed from Japanese investors, compounded by uncertain economic developments in Japan, preference for U.S. acquisitions, and lack of understanding of the benefits of the Free Trade Agreement.
- Further mergers in business services (law, accounting, consulting) are perceived as unlikely.

- Growing adoption of impediments to takeovers, (eg. non-voting shares, poison pills) inhibit bids (although no one suggested that Canadian corporate concentration, the usual explanation for lack of hostile takeovers, was a factor in this regard in the current and future business environments).
- Lack of financing for "financial" mergers due to high interest rates and withdrawal of lenders.
- Political developments in Canada, including the failure of Meech Lake and the election of an NDP government in Ontario, although the latter reportedly is a marginal consideration.

In most of the interviews conducted, it was not clear whether these concerns of the major dealers and M&A advisers were those of (potential) clients or of the individuals interviewed. Interestingly, however, none of these participants indicated a current lack of work in their departments at the time of the interviews.

2.3 Expectations of the M&A Community: The Positive View

A much more positive view on the likely level of future merger activity is expressed by those interviewees outside the securities brokerage business and the large-transaction financial advisers. Positive views are offered mainly by those firms that have a "middle market" clientele, and accordingly see more, but smaller, transactions than those dealing solely at the top tier.

The middle-market M&A advisers feel that the Free Trade Agreement and global re-structuring will have a greater impact among middle-market businesses than among the large corporations that, in many cases, own them. This is because it is the profitable but "non-core" medium-size, wholly-owned Canadian company that is likely to be put up for sale by a distressed U.S. or Canadian parent than is the parent company itself. It is the middle-market M&A advisory firms, rather than the large brokerage houses, that are likely to see the bulk of such transactions.

Other factors leading to a view of increased, or only slightly decreased, level of merger activity are the following:

- Regulatory change in many countries (eg. privatization, stronger antitrust law in Europe), giving rise to enhanced competition in the home market and leading to acquisitions abroad.
- There is enhanced competition in Canada due to government policies promoting trade liberalization and deregulation, which should lead to declining profitability and re-organization of firms in many industries.

- Under the Free Trade Agreement, the size threshold for Investment Canada review, which was perceived as one possible constraint to acquisitions by U.S. companies, has been significantly raised.
- Small but successful entrepreneurial businesses seeking to expand into the U.S. will find it easier to sell out to U.S. firms offering capital and distribution; similarly, family-run businesses facing succession problems will find it easier to sell out than previously.
- European and Japanese companies will want to have a North American presence to benefit from the Free Trade Agreement; some of this acquisition activity is expected to take place in Canada.
- The decline in the stock market has reduced both the share prices and the earnings multiples required to effect successful bids (eg. 21x in 1987 vs. 10x in the first half of 1990).
- Debt and equity capital funding for buyouts by management continues to be available; indeed the problem in recent years has been too few deals and too much available financing.
- A lower Canadian dollar and lower domestic interest rates are expected to prevail as the economy moves out of recession.

It will be noticed that factors that are interpreted negatively by the large dealers and merger advisers are given as positive reasons by the other interviewees, eg. impact of the Free Trade Agreement.

2.4 Review of the U.S. Literature

As the above divergence of views among knowledgeable M&A participants indicates, the determinants of merger activity are hard to identify and are subject to multiple interpretations. A brief review of the economic research in this area reveals a similar conclusion.

Merger movements in the U.S. have received considerable attention by researchers, the most convenient summary of which, up to the mid-1970's at least, is provided in Scherer (1980). Broadly speaking, three major "merger waves" can be identified by analyzing time series data collected by government agencies and information services; they are described in Exhibit 2.1.

EXHIBIT 2.1: MERGER WAVES IN THE UNITED STATES

- The Great Merger Wave, 1887 - 1904:
 - based on vast changes in transportation, communications, manufacturing technology, competition rules and legal institutions, resulting in the simultaneous consolidation of numerous producers into firms that dominated the markets they supplied
 - multi-firm mergers were prominent, 75% of mergers involving at least 5 firms in 3000 mergers between 1895 and 1904, eg. Standard Oil Company, U.S. Steel Corporation
 - 71 important oligopolistic or near-competitive industries were transformed into near monopolies
 - ended with the severe recession of 1904 and the Northern Securities case
- 1916 - 1929
 - following post-war adjustment, some 12,000 firms disappeared due to merger, about the same as in the previous wave, but with different characteristics
 - activity centered in electrical and gas utility sectors, creating giant holding companies; ie. previous monopolies grew without increasing monopoly powers
 - fewer manufacturing sector mergers due to antitrust law and the absence of as many potential targets as in previous wave
 - higher incidence of vertical integration and diversification or product line extension mergers; only 53% of mergers were horizontal
 - ended with stock market crash of 1929 and onset of Great Depression
- 1948 - 1975
 - high absolute level of merger activity, but different characteristics from previous periods
 - 1950 Celler-Kefauver anti-merger act and court decisions discouraged horizontal and vertical mergers entailing sizable market share shifts
 - trend toward conglomerate mergers and acquisitions abroad

Why merger activity takes on wave-like features has not been identified. Scherer notes that the only consistent correlate of merger activity is stock prices, reporting a strong correlation between the changes in the number of mergers per annum and stock price changes. However, this correlation was not observed during the stock market upsurge in 1971-72, the sharp decline in 1974, and the subsequent recovery in 1976. The mid-1970's was a time of "stagflation" that had not been experienced previously; moreover, the conglomerate acquisitions of the previous decade may have already been regarded as unsuccessful.

The absence of a relationship between merger activity and economic activity is surprising. It would appear then that merger activity is not significantly affected by cyclical economic behaviour, a finding that contradicts the claim that mergers have been motivated by the intense price competition that accompanies economic downturns and excess capacity.

In other research, Shugart and Tollison (1984) propose that merger activity follows a "random walk". Thus, the level of this year's merger activity would be equal to last year's level plus a random number with a zero expected value. The random walk characterization of U.S. merger activity is rejected by Golbe and White (1988). As a result, there is currently no satisfying explanation for the wave-like feature of U.S. merger activity.

In an attempt to assess, rather than forecast, merger activity, Scherer and Ravenscraft (1987) document the high proportion of mergers that fail to generate the expected financial results. The public policy implications of these findings are not clear, but the general conclusion that a large number of mergers are unprofitable after the transaction is completed is not likely to change corporate decisions where merger activity often is perceived to be the solution to a strategic problem such as global competition.

2.5 Review of the Canadian Literature

Green (1980) provides an historical analysis of merger trends in Canada that is quite similar to Scherer's description of U.S. merger activity. From the turn of the century onward, the waves peak in approximately the same periods, and all the Canadian merger booms except that of 1979 are associated with stock market booms. Moreover, he notes the declining percentage of horizontal mergers in Canada over the century, a finding confirmed by Baldwin and Gorecki (1986) for mergers in Canadian manufacturing during the period 1971-79.

Green attributes the correlation of merger activity with stock market activity to "the ease of disposal of corporate shares". It is not clear what he means by this. He seems to suggest that in a stock market boom, shareholders of targets believe that their shares are undervalued and are thus prepared to accept bids, while

shareholders of bidders think their shares are over-valued and are thus anxious to use them for acquiring more companies. Why these classes of investors should have such divergent opinions during a boom is unclear.

In a casual examination of Canadian mergers in the mid-1980's, Mason (1988) suggests that periods of relative economic stability, rather than growth, are more likely to generate merger activity because internal expansion is not available, while financing costs are lower than in times of rapid economic expansion. However, he does not test this view on data from other periods, and seems to imply that market share is the objective sought by businessmen in these periods but not in others.

In reviewing Canadian mergers since 1960, Brander (1988) notes the wave-like characteristics of the number of mergers per annum and rejects the view that they are consistent with a random walk interpretation. As with the research on U.S. merger activity, there is no satisfying explanation for the wave patterns observed in Canada.

2.6 Merger Research Generally

Brander and Golbe and White describe some methodological issues that make research into merger activity difficult. One key matter is the "cut off" point. Generally, only mergers above a certain dollar size of assets or transaction value (eg. \$10 million) are captured by information services or require notification by government agencies. Accordingly, a comprehensive file of all mergers and acquisitions is generally not available.

Moreover, inflation over long periods of time raises the nominal prices of assets and transaction values at which mergers and acquisitions are consummated. As a result, more transactions are recorded as time goes on, not because more mergers are necessarily occurring, but because inflation has raised their prices above the cut-off point and the recording agencies thus include them in their databases.

It would seem that the 1980's have seen unprecedented levels of merger and acquisition activity in both Canada and the United States. However, what is the standard against which this comparison is made? Golbe and White suggest that when the vastly increased size of the U.S. economy of the 1980's and the presence of so many potential merger partners is considered in relation to the turn-of-the-century conditions, the level of merger activity during 1980-87 is less significant than the merger wave at that time.

Perhaps it is for these reasons that so few clear relationships between merger waves and economic variables have been isolated.

2.7 Conclusions about Merger Activity

Basically, the perspective of the professionals at the large advisory and stock brokerage houses is biased due to their listed-company clientele and the transaction sizes that they typically deal with. Combined with their less well developed international affiliations when compared against their major U.S. competitors, as well as their tendency to respond based on prevailing conditions in the stock market, some weighting of their views is appropriate.

It may be that different factors support merger and acquisition activity over the course of the business cycle. As a result, no overall determinants can be readily identified. However, there appears to be broad agreement from the interviewees in this study that merger activity in Canada is now driven by strategic considerations, both domestic and international, and not by purely financial ones.

Noting the need to make comparable assessments of levels of merger activity over time, there is no particular reason to think that merger activity in Canada will decline significantly, because it has not been particularly high to begin with in the past few years as compared to past periods. Merger remains a standard business practice, unexceptional but for market power and foreign ownership concerns and press accounts, and it is more reasonable to conclude that merger activity will continue at a comparatively high level, than to conclude that major declines are likely.

CHAPTER 3: MAIN FEATURES OF EXPECTED MERGER ACTIVITY

Competition Act enforcers will be interested in not only the likely volume of merger activity, but also the features of future merger activity that may suggest market structure issues. The interviews with the M&A professionals have provided considerable insight into the features of the merger activity they expect.

Accordingly, this chapter will discuss the industries and sectors where merger activity is likely, the size of transactions, the expectation of foreign involvement, and the types of mergers based on market structure. Competition policy issues arising from these trends will be identified and compared with those of the past five years.

3.1 Industries and Sectors

All of the interviewees were asked to indicate which industries were likely to witness merger and acquisition activity over the period 1991-96. Perhaps for reasons of client confidentiality, there was some reluctance to be specific; however, there was general agreement on a relatively short list of industry candidates.

The list of industries and sectors is shown in Exhibit 3.1, accompanied by brief remarks offered by the M&A professionals. Trends in the financial sector are discussed in the following chapter.

Noting the reference in Exhibit 3.1 to the beer industry, while there was some speculation that the two largest brewers in Canada might merge, further links with foreign brewers seemed to be the major expectation, for example, through takeover or licensing of brand names. (The possible acquisition of U.S. brewers by Canadian firms was not identified, but the implications thereof are raised below.)

The list of industries is more interesting for what it does not show, than what it does indicate. It appears that the manufacturing and service sectors in Canada will be the ones "at risk", as opposed to natural resources. In some cases, the merger interest will be a result of pure industry rationalization due to poor profitability and outlook (eg. the food processing sector); in others, disposition as part of a return to core business (eg. Labatt-Canada Packers joint venture in flour).

In other cases, however, acquisition interest will arise because of the "soft assets" which the targets possess, eg. a patent, some unique technology or production process, a particular management strength, distribution networks, etc. This element of "goodwill" has been prominent in a number of acquisitions in Canada recently (eg. Institut Merieux-Connaught) and is not a feature that is restricted only to large firms.

**EXHIBIT 3.1:
SECTORS AND INDUSTRIES*
EXPECTED TO EXPERIENCE MERGER ACTIVITY**

Sector	Comments
1. Oil and gas	- amalgamation of junior companies, posing no competition policy concerns
2. Forest Products	- pulp and paper producers (re-cycling, regulations, value of Cnd \$) - lumber producers - "too many" small firms, affected by removal of subsidies
3. Packaging	- fragmented now, ripe for rationalization
4. Beer	- regulated, but further mergers likely
5. Airlines	- merger of domestic firms likely, unless U.S. partners found - global overcapacity
6. Steel	- Dofasco to sell or otherwise divest Algoma? - Stelco to seek joint venture partner
7. Food processing	- entire sector "up for grabs" due to Free Trade, e.g. Labatt joint venture in flour with Maple Leaf Mills
8. Business Services	- "over-banked, over-lawyered, over-accounted" - number of small firms will diminish

Sector	Comments
9. Financial services	- insurance companies, banks now permitted to own trust companies - mergers among the largest chartered banks
10. More mining and forestry joint ventures	
11. Food retailing in Quebec	
12. Distribution companies	- e.g. trucking
13. Retailing	- "Canadian firms failed in U.S.", re-focusing domestically
14. Auto parts manufacturers	- "small firms can't meet Japanese standards"
15. Furniture	
16. Pharmaceuticals	

This focus on "soft assets" raises certain issues for policy implementation. Clearly, goodwill is hard to value, and accordingly, legislation and regulations which specify quantitative asset thresholds as the basis for action or review may well understate the value of a firm's total assets. In general, historical-cost accounting systems will not produce the proper value of soft assets when they are on the firm's balance sheet (eg. capitalized research and development outlays), and will be even less useful when the soft assets do not appear in the accounts at all (eg. value of brand names, management skills).

3.2 Size of Transactions

Canada has seen significant merger activity in recent years, particularly with respect to large transactions. According to figures from *Mergers & Acquisitions In Canada*, there were twenty transactions valued at \$500 million in 1988-89.⁵

There is broad agreement that the number of large and highly-leveraged acquisitions will decline significantly. This is particularly true for "leveraged buyouts" the debt service for which is limited to the cash flows of the target itself. There is no doubt that debt will continue to fund a significant amount of each transaction. However, acquisition financing is likely to be more traditional, relying more on the creditworthiness and balance sheet of the bidder and involving more equity participation than previously required.

With regard to acquisitions of publicly-listed companies, Muir (1989) notes that transaction prices have not generally been high. There are over 2,500 companies listed on the two major stock exchanges in Canada. Each year there are perhaps 100-200 transactions involving public companies. Eliminating transactions exceeding \$1 billion, the average size of public transactions in Canada is less than \$50 million, and the median size is less than \$20 million.

Given the forecast for continuing expansion in merger and acquisition activity involving privately-held companies in the "middle market", the vast majority of transactions will continue to be in the \$10-50 million range. Together with the expected decline in the number of very large transactions, average transaction sizes should decline markedly. Management buyouts will continue to be a prominent feature of middle-market activity.

3.3 Extent of Foreign Involvement

The M&A professionals interviewed indicate continuing strong interest in buying Canadian companies on the part of foreigners. In relative terms, however, the interest is somewhat reduced due to political and economic events in Europe. Other factors cited as concerns to foreign investors include political uncertainty in Canada due to constitutional issues and the election of the NDP government in Ontario; however, these factors do not appear to be decisive as yet.

Among European investors, the United Kingdom appears to be the most interested in Canadian acquisitions; Canada ranks second to Australia in the minds of U.K. companies seeking to expand. The positive outcome of the review of the British Gas application to acquire Consumers Gas of Toronto is apparently being viewed by U.K. businesses as a signal of Canadian interest in attracting foreign investment.

German, French, and Italian corporations are seen as being mainly concerned with positioning to benefit from the Single Market in 1992 and with economic developments in Eastern Europe. This may be true in the near-term, but the restructuring of European industry will undoubtedly result in a high level of merger and takeover activity; accordingly, European-owned Canadian businesses may become candidates for divestiture. Change of control of these businesses within Europe or elsewhere can be expected after the rush to complete the Single Market is completed.

Japanese interest is harder to assess, in part perhaps because the M&A professionals interviewed do not typically deal with Japanese corporations. As noted earlier, the Canada-U.S. Free Trade Agreement has had only a limited impact on Japanese managers' investment decisions. Investment Canada notes that in its 1989-90 fiscal year, only 6.4% of the proposals it reviewed originated in Japan.

Hong Kong residents continue to arrive and invest in Canada, motivated by the change of government in 1997, the advantages they obtain under Canadian immigration regulations as business people and investors, and the difficulty of immigrating to the United States. Hong Kong investors have a strong interest in real estate and related acquisitions, and accordingly, except for a few well-publicized exceptions, appear not inclined to acquire Canadian manufacturing businesses. (Relating to immigration, there is a perception in Hong Kong that Canada's tax regime is onerous, as income of Canadian residents is taxed on a global basis. The opportunities for tax planning through the use of off-shore trusts are not well-known by wealthy Hong Kong residents.)

The United States continues to be viewed as the major foreign investor, although as noted earlier, the large dealers and financial advisers indicate that they have seen much less Free Trade-related acquisition activity than they might have expected from the Americans, whether as buyers or sellers of Canadian companies. In 1989-90, the United States remained by far the largest source of foreign investment in Canada, with about 52% of all investment proposals reviewed by Investment Canada coming from U.S. residents and companies.⁶

As an observation, it may be that the major near-term impact of the Free Trade Agreement is the extent of Canadian acquisitions of companies and assets in the United States.

3.4 Market Structures

M&A professionals are unanimous in their view that conglomerate (or "financial") mergers are at an end in Canada. They suggest that much of the merger activity of the past few years results from disposals of conglomerate related acquisitions made in the past two decades. As unrelated business units are sold off, the buyers are typically those already in the same or closely related industries.

The interviewees cite a variety of motives regarding the renewed interest in horizontal mergers: increasing market share and hence (supposedly) profitability; gaining access to strategic assets; enhanced market power for dealing with suppliers; economies of scale and scope as tariffs and other trade barriers fall. These factors are among the reasons usually advanced to justify mergers and acquisitions.

None of the interviewees expects a significant number of vertical mergers. However, joint ventures in manufacturing and in research and development are expected to become more prevalent.

3.5 Competition Policy Issues:

The trends noted above by M&A professionals suggest that merger activity over the next five years may pose some policy issues not previously or often considered or experienced in administering the Competition Act since its inception in 1986. (Some of the points below will be discussed in greater detail in Chapter 5.)

(1) Market Definition

Several advisers and legal counsel feel that, as most of the foreign buyers and sellers of Canadian companies are U.S.-based, the appropriate geographic market is North America as a whole for evaluating market share and concentration. (This view indicates a failure by those professionals to appreciate the techniques of market definition commonly adopted in competition policy and anti-trust evaluations in Canada and the United States.) The M&A professionals also perceive a current focus on the domestic market share which, they consider, prevents desirable mergers and acquisitions.

(2) Soft Assets

The increasing focus on "soft assets" (such as patents, specialized technology, brand names, particular management expertise and other such goodwill) as the motivator for mergers suggests more transactions in emerging, technology-based fields, as opposed to natural resources. Mergers involving De Havilland and Connaught Labs illustrate transactions of this type, and may be particularly sensitive if the acquirer is a subsidized business.

Accordingly, merger transactions motivated by strategic objectives may become prominent. For example, mergers to acquire, but specifically not to use, research results may have a "barriers to entry" purpose.

Arrangements other than mergers may give rise to the same concerns. For example, licensing may achieve the same access to the "soft asset". Accordingly, competition policy enforcement may need to place increasing emphasis on licensing agreements with restrictive provisions, which might well entail "non-compete" arrangements in various markets.

(3) Joint Ventures

The Competition Act expressly provides for specialization agreements and consortia, but the evaluation of these arrangements is difficult. In this regard, the observation that joint ventures are likely to become more prevalent raises issues concerning the efficiencies of such arrangements. Do they achieve some commercial purpose that could not be achieved in other ways, or are they designed expressly to organize and co-ordinate activity among firms that should be competitors?

There is at least one research-and-development joint venture involving Canadian companies (Precarn), and several manufacturing ventures involving Japanese firms (eg. Stelco-Mitsubishi).

(4) Vertical Mergers

The apparent dearth of vertical mergers expected by the M&A professionals could well be a mis-interpretation. The absence of such mergers may reflect, for example, plans by businesses to expand vertically from within (perhaps including a non-notifiable acquisition of a small business to facilitate such expansion).

It may also be that the M&A community does not appreciate the economic basis for vertical mergers and the types of efficiencies attained thereby. At base, vertical integration is a means of reducing the transaction costs associated with alternate forms of organizing economic activity (eg. common ownership of the stages within oil refining, or of the stages within steel manufacturing). Accordingly, they may incorrectly expect few to arise.

Moreover, the M&A community may be failing to appreciate the possible strategic purposes of vertical mergers. In industries with dominant firms, integration can place rivals at a strategic disadvantage by posing impediments to entry.⁷ Considering the increasingly global nature of production and trade, vertical integration by dominant firms may well be more prevalent in the next few years.

(5) Government Ownership and Regulation

Acquisitions by government-owned or controlled businesses as well as by firms in regulated industries may raise competition policy questions, particularly when the business being acquired is operating on a fully commercial basis in the private sector.

Acquisitions by telephone and cable signal providers of manufacturing businesses (eg. in cellular telephones) represent clear examples of domestic firms taking this route. The Merieux purchase of Connaught is an example of a foreign, public sector affiliate doing the same thing.

Private-sector acquisitions by entities fully or partially "privatized" by governments in Canada and abroad, as well as acquisitions by regulated companies, raise the prospects of extension of market power as well as cross-subsidization wherein the acquired company benefits from the regulated status of its parent, eg. with respect to financing. For example, cable television companies borrow, in part, on the strength of their exclusive cable franchises (or licenses). They are able, therefore, to finance their non-regulated subsidiaries at their preferred rates and therefore provide lower-cost financing than competitors not so linked could achieve.

Similarly, state-owned corporations may borrow on the strength of a government guarantee or a call on the government's consolidated revenue fund, and therefore have the capability to fund their commercial activities, and those of their subsidiaries, at rates applicable to the government.

(6) Foreign Investment in Canada

Foreign interest in the acquisition of Canadian companies is expected to remain high. A number of competition policy issues arise in this context, particularly in relation to the Canada-U.S. Free Trade Agreement.

No competition policy question is likely to arise when a foreign firm enters the Canadian market through "*de novo*" entry. However, foreign acquisitions and joint ventures pose the question of the lessening of potential competition. If it is determined that the foreign acquirer/venturer is either likely to have employed "*de novo*" entry, or was perceived by established firms as a likely "*de novo*" entrant, the acquisition has the effect of removing this potential entrant and its restraining influence on pricing behaviour of the current actual participants. That is, the foreign acquirer will be unwilling to compete with its newly-acquired Canadian subsidiary, and will operate under an implicit or explicit non-compete agreement.

"Contestability" of the domestic market may work in both directions. A U.S. acquisition of a Canadian business may reduce potential competition in the Canadian market. Similarly, a Canadian acquisition in the U.S. market could also eliminate a potential competitor from the Canadian market. As a consequence, Canadian authorities may see fit to intervene in both circumstances, in the first instance, through merger review under the Competition Act and in the second through raising Canadian concerns with U.S. anti-trust agencies.

There is an on-going debate about the proper conditions for a market to be "contestable". If three conditions are satisfied: (i) all potential producers have access to the same technical and productive characteristics; (ii) consumers respond quickly to price changes, and yet, (iii) the established firms cannot respond swiftly enough when a potential entrant sets up for business at cheaper prices; then in the absence of sunk costs, there will be no barriers to entry and price will fall to average cost. In such a "perfectly contestable market", the acquisition of a competitor cannot convey market power, and accordingly, any economic profits must be attributable to some other factor.

Contestability theory is subject to continuing refinement, particularly with regard to the nature of the "sunk costs" that prevent its attainment and the differences in "rules of the game" before and after entry. The concept was tested in the case of U.S. airline de-regulation, in which economic profits were observed despite the potential for entry on routes. Such profits may reflect the continued imperfections due to airport ownership, landing fees, and other administered rules which did not change with de-regulation of fares and routes.

CHAPTER 4: MERGERS AND ACQUISITIONS IN THE FINANCIAL SECTOR

The Canadian financial sector is perhaps the one that is most likely to witness merger and acquisition activity over the next five years. The federal government has just recently introduced draft legislation regarding financial sector reform (ie. Bill C-83 and Bill C-95), and this legislation, when enacted, will permit and stimulate the re-structuring of the industry. However, the need for re-structuring has been clear for several years now and it will occur to some extent, whether the legislation is adopted or not.

The view that mergers and acquisitions are likely to occur in the financial sector is shared by all the M&A professionals interviewed in connection with this report.

While all of the financial service industries will experience some measure of merger and acquisition activity as a result of the proposed financial reform legislation, the most prominent examples are the large chartered banks and the property and casualty insurance business.

4.1 Chartered Banks

There are seven widely-owned banks in Canada chartered under the Bank Act, and the six largest are the largest banks in terms of assets that are licensed under that Act. Collectively they are referred to as the Schedule I banks. Although they cannot be acquired in a hostile takeover due to ownership rules in the Bank Act, the federal government has permitted mergers of Schedule I banks both to maintain solvency and to facilitate business strategies of those institutions.

It would be fair to say that globalization has proceeded further in the financial sector than in any other industry. Competition is intense, profit margins are low in internationally-traded financial services, and the Schedule I banks that had been among the world's largest institutions have dropped in ranking to the 50th to 60th positions in terms of assets.

The Economic Council of Canada has documented that the Schedule I banks have re-focussed their activities on the domestic market, having attempted and largely failed to develop into broadly-based global competitors. In conjunction with the economic slowdown and the stronger capital-adequacy rules imposed by the Office of the Superintendent of Financial Institutions (OSFI), the relatively small domestic market will afford the Schedule I banks a slow-growth environment for the foreseeable future. For this reason, the Schedule I banks have insisted on additional powers in recent years to enter the securities and insurance sectors, and to offer data processing and leasing services.

In this environment, mergers among the Schedule I banks cannot be ruled out. The Bank of Nova Scotia and the National Bank have been identified as merger targets due to their relatively small size and weak financial position respectively. As well, the Bank of Nova Scotia has been linked with the Toronto-Dominion Bank in press accounts. Such transactions, if they were permitted, would involve the smallest of the Schedule I banks.

However, while they are much less likely, mergers among the larger Schedule I banks cannot be ruled out either. A merger between the Bank of Montreal and the Canadian Imperial Bank of Commerce makes sense strategically and would create a financial institution of global scale, while benefitting from a rationalization of the domestic branch system.

Mergers among Schedule I banks would not necessarily raise particularly serious questions for competition policy. Most chartered banks are in a variety of businesses (eg. corporate loans, residential mortgages, savings products, retail securities, etc.), each of which would have to be analyzed in the event of a merger proposal. It may be that such analyses would show acceptable structural ratios in certain businesses, given the activity of non-Schedule I banks, other domestic financial institutions and foreigners.

The larger question surrounding the structure of domestic markets for chartered banks remains one of broader public policy. Essentially, it has been government policy to prevent foreign banks and non-bank rivals from competing in Canada on an equal basis with the Schedule I banks. The closely-held foreign banks licensed under the Bank Act (ie. the Schedule II banks) are limited to collective ownership of not more than 12% of the domestic assets of the banking system and face prudential lending limits that restrict the size of any loan they grant to their equity base. Schedule I banks face no such restrictions (although the OSFI does scrutinize loan concentrations).

Under the Canada-U.S. Free Trade Agreement, wholly-owned American Schedule II banks will be subject to the same regulatory regime as the Schedule I banks while the non-U.S. Schedule II banks continue to be at a regulatory disadvantage. An initial reading of the proposed federal financial reform legislation suggests a greater opportunity for foreign and non-bank entry into Canadian banking markets, but only through the start-up or acquisition of a Schedule II bank or trust company.

Accordingly, the structural restrictions favouring the Schedule I banks continue to be in effect. However, the new avenues for entry by non-bank and foreign institutions will increase competition in certain domestic banking markets and will likely hasten, rather than delay, mergers among the largest banks.

A related question for competition policy is the possibility of a Schedule I bank taking on a 10% foreign shareholder in return for access to the partner's international network. Given the size of the Schedule I banks, such an investment in a Canadian chartered bank would represent a very substantial amount of money. Such an agreement, while not giving voting control to the foreign shareholder, would likely implicitly or explicitly prevent the foreigner from competing with the Schedule I bank in Canada and perhaps from doing business with Canadian corporations abroad. The agreement therefore would remove either an actual or potential competitor from the domestic market.

4.2 Property and Casualty Insurers

Among the financial services, the property and casualty insurance (P&C) industry appears to come the closest to meeting the classic conditions for restructuring through mergers and acquisitions. It is widely agreed that there are far too many domestic competitors (although spokespeople who hold this view rarely indicate how many competitors there should be or why), none of whom have a significant market share. Profitability is regarded as weak based on persistent underwriting losses (which may be compensated for by investment income), and most of the companies are wholly-owned subsidiaries of foreign insurers. The domestic market is growing slowly at best, while the Ontario Government has stated its intention to introduce a public system of automobile insurance.

As a result of poor growth prospects, U.S. shareholders appear unwilling to inject additional capital into their Canadian P&C operations, and several have sold these businesses. Of 17 sales of P&C insurance companies in Canada from 1984-89, 11 were sold by U.S. companies. The buyers were European (8), Canadian (6), and U.S. insurers (3).⁸

In several cases, a foreign firm owns more than one Canadian P&C insurer. Assurance General du France controls Insurance Group of Canada West Ltd. in Edmonton and Canadian Surety Co. of Toronto. In 1989, Nationale-Nederlanden NV of the Netherlands acquired Groupe Commerce Compagnie d'Assurances and Compagnie d'Assurances Belair of Quebec, while also controlling Halifax Insurance Co. of Toronto and Western Union Insurance Co. of Calgary.

The general model appears to be that U.S. insurers are withdrawing, while European insurers are entering by acquisition with the intent of increasing market share and scale economies, and reducing expenses. Japanese insurers have reportedly made several passive investments in Canada and are expected to begin significant underwriting activities during the 1990's.

Given the fragmented competition among P&C insurers, the fact that foreigners are entering the Canadian market through acquisition does not yet indicate any lessening of direct competition. However, it is very clear that the

foreign parent will not be competing for Canadian business with its own Canadian subsidiary; hence, each such acquisition reduces a source of "potential competition" to the extent that "*de novo*" entry by the foreigner was regarded as an alternative to entry by acquisition.

Provided they were otherwise able to meet provincial licensing requirements, foreign P&C insurers could sell insurance in Canada on a "*de novo*" entry basis. Accordingly, potential competition from off-shore P&C insurers appears to exist, but is being reduced by foreign acquisitions in Canada.

The same issues arise under the proposed federal financial reform legislation that permits banks to own insurance companies, but not to distribute insurance products through the bank's branch system. It is highly likely that several banks will enter the P&C insurance business, but it is highly unlikely that they will do so by starting operations "*de novo*", in part because they cannot distribute insurance products through their branch networks under Bill C-95. Bank entry by acquisition will thus reduce the pool of potential competitors.

Given the trend toward continued rationalization in the P&C insurance market and the absence of potential competition as a restraining force on actual rivals, competition policy might be legitimately interested in preserving the present level of competition despite the very low levels of market share that currently exist.

Special concerns may arise in automobile insurance, with the expected development of a public insurance system in Ontario. Details are not available at this time, but one wonders what it means for competition in other provinces when a major market is (presumably) lost.

CHAPTER 5: POSSIBLE IMPLICATIONS FOR COMPETITION ACT ENFORCEMENT

The points discussed below have arisen specifically in the context of this inquiry into prospective merger activity and may be relevant to the implementation of the Bureau's Merger Guidelines which were published in April 1991.

This report notes the issues and the associated literature. It may be appropriate to discuss some of the issues in greater detail in subsequent reports.

1. Herfindahl Concentration, Rivalry and Mergers

"Market power" is a key concept in assessing mergers in Canada and the United States. In the United States, the standard approach is to define the relevant market, compute the market shares of the merging parties and the merged unit, and then decide whether that share will support an inference of market power that is sufficient to challenge the transaction.

The approach to merger review in Canada is somewhat different, and accordingly, an index other than market share may be useful. Landes and Posner (1981) contend that the more appropriate measure of market power is the ability of a firm to raise the price of its product above marginal cost and that market share is only one of various factors relevant to that ability.

Using the Lerner index, they demonstrate that the market elasticity of demand, and the supply elasticity and size of competitive fringe firms also affect the ability of a dominant firm to raise price above marginal cost. More relevant for the Canadian situation, however, is the case where the industry is composed of two or more large, non-price-taking, and possibly interdependent firms. Ordover, Sykes and Willig (1982) propose an index of industry-wide market power which emphasizes inter-firm rivalry. They also demonstrate the relationship between their index and the Herfindahl Concentration Index.

2. Goals of Merger Policy: Economic Efficiency vs. Price Restraint

There is a continuing debate among legal and economic researchers in the United States about the proper goal of antitrust policy. This debate may be relevant for the enforcement of Canadian merger policy because of its explicit endorsement of demonstrated efficiencies as a defense. Unresolved in the U.S. is whether antitrust rules should be oriented to preventing inefficiencies that may arise from mergers, or to preventing the price increases that may result from mergers which enhance market power.

For example, a merger between two large cigarette companies might result in significant price increases, but impose only minor deadweight losses due to the inelastic consumer demand for the product. Moreover, such inefficiencies might be so small that non-pecuniary efficiency gains might easily outweigh them. Accordingly, a competition policy that emphasizes global efficiency concerns might have no choice but to approve the merger.

It has been suggested that U.S. antitrust policy was motivated by price-setting, rather than efficiency, concerns. On this "price standard", price-raising mergers that were economically efficient would nevertheless be stopped. Fisher, Johnson and Lande (1989) support the application of the price standard but argue that the merger should be approved **when the efficiencies are large enough to prevent the price from increasing**. They argue that a price standard is both a more appropriate basis for merger policy and is more workable than an "efficiency standard", and they present a method for determining how large the efficiencies must be under a variety of industry structures.

In some respects, the situation could be clearer in Canada. The Bureau requires that non-pecuniary efficiencies exceed any inefficiencies resulting from an otherwise anti-competitive merger. However, statements made by senior Bureau officials in the recent past suggest the Bureau in this regard might require that such gains be passed on to consumers, thereby reducing the benefits from any exercise of market power.

3. Competition Policy and Strategic Business Behaviour

The possibilities of strategic entry deterrence in connection with acquisitions of "soft assets" and of vertical mergers as a way of raising rivals' costs were suggested above as features of future merger activity. The significance of strategic behaviour for competition policy enforcement is not at all clear. Is all strategic behaviour necessarily anti-competitive? The literature does not seem to answer this question definitively.

In fact, there appear to be three rather distinct literatures bearing on business strategy: the "business school" approach typified by Porter (1980), the more traditional economics literature that emphasized only a few strategic issues such as limit pricing and predatory pricing, and the more recent game theory approaches to oligopoly. The competition policy implications of these literatures are not necessarily congruent.

Of clear concern, for example, is strategic investment, wherein the incumbent makes irreversible commitments that affect his costs sufficiently that the post-entry price of the product would be unprofitable for the entrant. Other examples of strategic entry-detering conduct include:

- (a) learning by doing, wherein the incumbent increases production to get further down the learning curve, lowering his marginal costs and the post-entry price.
- (b) research and development designed to lower one's own cost and post-entry price, as well as pre-emptive patenting which does not lower one's own cost, but raises the cost of entry.
- (c) product selection, wherein the incumbent "fills up" the product space through product or brand proliferation, leaving no viable niche for an entrant.

Such strategies have the effect of changing the entrant's best responses. At the same time, they are indistinguishable from non-strategic economic activity (ie. of production, risk-taking, etc.) except in the intent, which is to deter potential rivals.

Holt and Scheffman (1988) have suggested that the business strategy literatures may not be very helpful in identifying anti-competitive behaviour. The policy implications are quite important, however. As a strong proponent of strategic business behaviour, Porter (1989) nonetheless clearly identifies stringent competition policy enforcement as a key element in national economic development and in promoting international competitiveness.

4. Competition Policy Approach Toward High-Technology Industries

Precarn Associates is a Canadian industry-led scientific research consortium in Ottawa specializing in artificial intelligence and robotics systems. The non-profit venture brings together investigators from industry and universities and its focus is "pre-competitive research"--work that precedes commercial development. Its members include CAE Industries Inc., Ontario Hydro, and Stelco Inc.⁹ Although the political environment is moving in the direction of supporting such joint ventures, the economic justification for such cooperation is not clear. Ordover and Baumol (1988) analyze the policy issues in detail.

5. Efficiencies in Joint Ventures

There is some suggestion that joint ventures in both manufacturing and research and development will be used more frequently in Canada in the coming years. Competition policy will be concerned with identifying the efficiencies that can reasonably be expected from such arrangements.

Citing the on-going joint venture between General Motors and Toyota to build a subcompact car in the U.S., Pidano and Silvia (1984) point out that the joint venture may promote the diffusion of resource-saving techniques, giving GM the opportunity to understand fully the highly successful Japanese management and

production system. The application of such learning could save GM millions of dollars when applying these techniques to its own plants. However, GM already had a Japanese affiliate (Isuzu), leading the Federal Trade Commission to substantially reduce the amount and value of joint-venture learning that would be generated.

Silvia (1987) analyzes the efficiency claims often asserted by proponents of such arrangements; that is, input complementarities. He concludes that the existence of input complementarities is not a sufficient condition for a joint venture to be more efficient than other modes of organization, and suggests that transaction cost savings are paramount in joint venture formation.

6. Competition Policy and Direct Foreign Investment

As indicated in Chapter 4, the acquisition of Canadian companies by foreigners is not necessarily pro-competitive, as it may reduce the number of potential "*de novo*" entrants. Thus, a competition policy that relies on foreign competition to correct domestic industry distortions could be somewhat more questioning of the role of foreign takeovers in that industry.

The relationship between competition policy and foreign investment (inward and outward) is the subject of continuing research. A high level of enforcement regarding mergers may result in, eg. more joint venture activity in the domestic market and/or more investment abroad by domestic firms. Nelson and Silvia (1985) discuss the relationship between U.S. antitrust policy and direct foreign investment.

7. Overall Implications

The general sense of this report is that while merger activity in Canada will remain high during the 1991-96 period, it will likely raise different sets of issues for competition policy enforcement and for merger advisers. The search for "soft assets", the impact of mergers on potential competition; the increasing use of joint ventures, along with continuing de-regulation and privatization all raise new issues as compared with merger activity in a natural resource-based economy.

Regrettably, as a result of weak anti-combines legislation prior to the Competition Act of 1986, there are few cases and decisions to guide governments and business in this new business environment. Legal counsel and merger advisers may not be particularly well prepared for this new environment, lacking both a history of cases and judicial decisions as well as a comprehensive understanding of developments in economic reasoning. There will likely be an attempt to employ economic concepts uncritically, and thus impose a heavier-than-necessary burden on enforcement officials. As a result, there is a clear need for informative merger guidelines that are themselves informed by the research and concepts in economics and industrial organization developed over the last twenty

years. The Bureau's Merger Guidelines, which were published in April 1991, are expected to satisfy this requirement.

At the same time, it should be remembered that economics is primarily a field of research and intellectual inquiry. Many of the concepts will not lend themselves to easy application in all circumstances. Moreover, ideas about competition change; what is accepted today may be unrespectable tomorrow. An example is found in comparing "transaction cost economics" with "contestability theory". The former type of reasoning is based on "asset specificity", the idea being that where an asset has few alternative uses, a different mode of organization will be adopted from that where an asset has numerous alternative applications.

By contrast, contestability theory is premised on there being almost no asset specificity at all. Thus, where assets are easily moved to new applications, competitive conditions prevail based on the threat of entry. It is hard to see that transactions cost concerns and contestability theory could both support a claim of efficiency (as, for example, has been suggested by the work of Neave and Nathan on Canadian financial markets).

Accordingly, process may matter as much as policy in getting to the right decision. The author proposes that merger guidelines should have the same status in Canada as do those in the United States Federal Trade Commission and the Department of Justice, ie. as an "internal memo" that enforcement officials use for their own purposes, but which has no legal significance.

A major purpose of public merger guidelines should be the stimulation of legal and economic thinking. Unlike the situation in the United States, there is no significant research literature on the subjects of mergers or competition policy in Canada. A forum for such research and policy debate would be a welcome addition.

¹ S. Johnson (1990) describes these measures more fully.

² Unpublished work of Professor Howard Perlmutter, Department of Management, Wharton School, University of Pennsylvania, Philadelphia, Pa., cited by Mr. Preston Townley, president of the Conference Board, New York, in a speech excerpted in the *Globe & Mail*, Report on Business, August 3, 1990, p. B3. A copy of the related research papers has been requested from Professor Perlmutter, but not received.

³ See Investment Canada (1990), p. 83.

⁴ An official of Investment Canada notes that in the case of oil and gas sector mergers, the agency solicits input from the Department of Energy, Mines and Resources, the Petroleum Monitoring Agency, and the provincial governments involved.

Investment Canada will apply a "net benefit" test to establish that a takeover is compatible with national industrial, economic and cultural policies as initiated by the government. In the oil and gas sector, the policy of Energy, Mines and Resources is that financially sound Canadian firms cannot be sold to foreign interests. The threshold for Investment Canada review of oil and gas acquisitions by American firms was not raised by the Free Trade Agreement and remains at \$5 million.

- 5 As reported in "The Annual Review, 1990", chapter 2.
- 6 From 1989-90 Annual Report of Investment Canada, cited in Globe & Mail, Report on Business, October 12, 1990, p. B3.
- 7 Williamson (1985) concludes that vertical integration enhances efficiency when driven by transaction-cost concerns. He notes that integration by dominant firms poses "cost of capital" barriers and results in a variety of tactics to penalize actual and potential competitors (p. 100).
- 8 See Globe & Mail, "European insurers raise stakes in Canada", Report on Business, October 1, 1990, p. B26.
- 9 See interview with Gordon MacNabb, Financial Times of Canada, October 8, 1990, p. 39.

**APPENDIX A:
LIST OF M & A PROFESSIONALS INTERVIEWED**

Investment Dealers

David Ward
Managing Director, M & A
Burns Fry

Tom Rahilly
Vice President
Saloman Canada Inc.

Jim McDonald
Deputy Chairman, M & A
Scotia-McLeod Inc.

Tom Muir
Vice-President and Director, M & A
ABC Dominion Securities

Gord Howell
Vice President, Corporate Finance
Nesbitt, Thomson

Banks:

Jack Moallem
Vice President, Head of M & A
Citibank Canada

Dr. John C. Pattison
Senior Vice President
Canadian Imperial Bank of Commerce

Accountants:

Phil Doherty
Partner-in-Charge
Corporate Finance Group
Peat Marwick Thorne

Mike Jamani
Partner, Corporate Finance
Ernst & Young

Competition Act Counsel:

Lorie Waisberg
Goodman and Goodman

Tim Kennish
Osler, Hoskin & Harcourt

Lawson Hunter
Fraser and Beatty

Bruce McDonald
Lang, Michener

Other M & A-Related Firms:

David Main
Bain & Co. Canada Inc.

Mel Hawkrigg
Trilon Corp.

Mark Wheaton
Director
Lancaster Group

Gordon Sharwood
President
Sharwood and Company

George Kitching
Senior Vice President
Rothschild Canada Inc.

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