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An estimate of the share of mergers and acquisitions (M&A) in French BoP direct investment statistics in equity capital

by

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1. Mergers and acquisitions (M&As) are a big part of the corporate finance world. Every day, investment bankers arrange M&A transactions that bring together separate companies to make larger ones. Deals can be worth hundreds of millions of euros and often make the news. A parallel has often been drawn between cross-border M&A growth at the end of the 1990s and that in direct investment flows, but it is very difficult to establish a clear link between the two because the foreign direct investment (FDI) statistics do not highlight the **share of M&A in direct investment**. However, this share is important from an analytical point of view: the impact of M&As on home and host economies differs indeed from the impact of other types of direct investment (such as greenfield investments or extensions of capital).

1. Definition and financing of the M&As

1.1. Definitions

2. All M&As have one common goal: they are all meant to create **synergy** that makes the value of the combined companies greater than the sum of the two parts, because the companies can gain a greater market share or achieve greater efficiency. By merging, the companies hope to benefit from synergy resulting of staff reductions, economies of scale, acquisition of a new technology or improvement in the reaching of new market or in the industry visibility.

3. Even if the terms are used as if they were synonymous, “merger” and “acquisition” do not mean the same thing: an “acquisition” is a purchase where a company takes over another one and becomes the new owner. A merger occurs when two (or more) firms (about the same size in a “merger of equals”) agree to go forward as a new single company rather than remain separated. We have to notice however that this distinction is not always so clear in practice: one company shall buy another and, as part of the deal’s terms, allow the target firm to proclaim that the transaction is a merger of equals, even if it is technically an acquisition.

4. When the acquiring firm is larger than the target company, the acquisition is called a **take-over**. When the target company is bigger than the acquiring company, it is a **reverse take-over**.

5. According to the result of the operation, different types of mergers can be defined:
   - A **statutory merger** occurs when the target company ceases to exist.
   - A **subsidiary merger** relates to a transaction where the acquired company becomes a subsidiary of the parent company.
   - **Consolidation** is a type of merger where the companies join to form an entirely new company. The individual companies cease to exist and their shareholders become shareholders of the new company.
   - A **reverse merger** is a deal where the acquiring company ceases to exist and merges into the target company. If a company is eager to get publicly-listed in a short period of time, it can buy a publicly-listed company and merges into it in order to become a new public corporation with tradable shares.

6. Different varieties of mergers can be distinguished from the perspective of business structures:
   - A **horizontal merger** occurs between two companies in direct competition in the same product lines and markets.
   - A **vertical merger** occurs between two companies with complementary activities such those having a buyer-seller relationship.

- A **market-extension merger** occurs between two companies selling the same products in different markets.
- A **product-extension merger** occurs between two companies selling different but related products in the same market.
- A **conglomeration or conglomerate merger** relates to all the other types of transactions, i.e. when two companies do not have a specific relationship and are usually in different lines of business.

7. **Divestment** (or break-up or de-merger) involves the separation of a business unit or subsidiary from the parent. Many advantages may be expected: a divestment can help a company raise additional equity funds or boost a company's valuation by providing powerful incentives to the people who work in the separating unit. It can help also management of the parent company to focus on core operations. Besides, shareholders get better information about the business unit because it issues separate financial statements: with separate financial disclosures, visibility of investors on the value of the parent corporation improves and the parent company might attract more investors and ultimately more capital.

8. There are several restructuring methods:
- A **corporate sell-off** is the sale of a subsidiary to buyers which are other companies in most cases. Sell-offs are done when the subsidiary does not fit into the parent company's core strategy. They also raise cash which can be used to pay off debt. Two special cases are Management Buy-Out or MBO (when the managers and/or executives of a company purchase controlling interest in the company from former shareholders) and Management Buy-In or MBI (when a group of investors outside of a company purchase a controlling block of shares and keep the existing management).
- A **corporate spin-off** occurs when a subsidiary becomes an independent entity, with a distinct management and board. The parent firm distributes shares of the subsidiary to its shareholders through a stock dividend (there is no cash generated for the parent company).
- An **equity carve-out** is the operation consisting for a parent firm to take a subsidiary public through an initial public offering of shares, amounting to a partial sell-off. A new publicly-listed company is created, but the parent keeps a controlling stake in the newly traded subsidiary. An equity carve-out generates cash for the parent company.
- A publicly held company can isolate the value of one segment of the company by issuing **tracking stocks** in order that the different segments of the firm may be valued differently by investors. The company retains control over the tracked segment and tracking stocks do not grant shareholders the same voting rights as those of the main stock.

1.2. Types of financing and impact on the recording in the balance of payments

9. Two types of M&A can be distinguished according to the perspective of how the transaction is financed:
- The **purchase M&A** occurs when one company purchases another one. The purchase is made by cash or through the issue of some kind of debt instrument.
- In a **consolidation M&A**, a brand new company is formed and both companies are bought and combined under the new entity. The shareholders bring the shares of both merging companies and receive in exchange shares of the new company. There may be no cash payment at all.

10. Each type has implications for the recording of the transaction in balance of payments. The simplest case of a purchase M&A occurs when a resident direct investor itself acquires a new

non resident direct investment enterprise: there is an outward direct investment flow in equity capital in the balance of payments of the direct investor.

11. However, given companies' international dimension, a large number of transactions are not carried out by the parent company of the acquiring group but by a subsidiary located (or not) in the country of the acquired company. In this case, the method for recording an M&A transaction in the balance of payments will depend on the way in which the operation is financed:
    - If the parent company finances its subsidiary through a capital increase, the M&A will be considered as an equity capital transaction.
    - If an inter-company loan is extended, the transaction will be recorded under other capital (as an FDI transaction).
    - If the subsidiary opts for another solution, such as issuing a debt instrument on the financial market or borrowing from the banking system, the recording in the balance payments will be limited to the part financed by non residents and will not appear under direct investment but under portfolio investment or other investment. If the source of financing is only local, the M&A will not give rise to any balance of payments flow.

12. To illustrate, consider the case of a **Leveraged Buy-Out (LBO)**. It is a strategy involving the acquisition of another company using borrowed money (bonds or loans). The acquiring company uses its own assets as collateral for the loan in hopes that the future cash flows will cover the loan payments. There is usually a ratio of 90% debt to 10% equity.
    Parent company: Company A in Country 1
    Acquiring company (subsidiary of A): Company B in Country 2
    Target company: Company C in Country 2
    Seller company: Company D in Country 3
    The value of the target company is 100. To finance this operation, Company A makes a capital contribution of 10 in Company B, which takes over the Company C. Besides, the Company B borrows 30 from a bank resident in Country 4 and 60 from banks resident in Country 2.

13. The recording in the balance of payments of the different countries will be the following:

	Country 1	Country 2	Country 3	Country 4
Direct investment abroad	-10		+100	
Direct investment in the reporting economy		+10-100=-90		
Other investment – Assets				-30
Other investment – Liabilities		+30		

14. Two remarks on this case: the direct investment flow in the country of the direct investor (Country 1) is limited to 10% of the value of the M&A and there is a net direct divestment in the country of the target company (Country 2).

15. An increasing number of M&As is financed by **exchange of securities** as opposed to cash payments. In this case, the acquiring company and the target company are merging into a new company and the sellers are receiving shares of this new firm in exchange of their shares of the target company, according to the terms of exchange that have been decided.

16. Consider the following example where the target company is owned by two direct investors :
    Acquiring company: Company A in Country 1
    Target company: Company B in Country 2
    First seller company (owns 60% of B): Company C in Country 3

Second seller company (owns 40% of B): Company D in Country 4
The value of the target company is 100. The value of the new group resulting from the merge of the acquiring company and the target company is 500.

17. The recording in the balance of payments of the different countries will be the following:

	Country 1	Country 2	Country 3	Country 4
Direct investment abroad	-100		+60-60=0	+40
Direct investment in the reporting economy	+60	-100+100=0		
Portfolio investment – Assets				-40
Portfolio investment – Liabilities	+40			

18. Two remarks on this case:
- From the point of view of the compilers of the country of the target country, this transaction could be ignored because the transaction is between non-residents. However, the counterpart countries are not the same: before the M&A, the owners were located in the countries 3 and 4; after the M&A, they are located in the country 1. In order to avoid bilateral asymmetries, the country of the target company should simultaneously record a divestment and an investment, respectively with the countries of the sellers and with the country of the acquiring company.
- A key point is to check whether the return investment flows offsetting the direct investment transaction include acquisitions of shares over the 10% threshold in the new company resulting from the merge. More specifically, it is important to determine exactly the amount and the origin of the securities of the new company that constitute the payment.

2. Estimate methodology and results

19. The purpose of the study is to estimate the share of the cross-border M&A transactions in the direct investment statistics of the French balance of payments. There are generally two forms of direct investment in equity capital: M&As which involve the transfer of ownership of the assets of the target company to the acquiring company, and creation of subsidiaries (greenfield investment) or extension of established subsidiaries' capacity. These last operations differ from M&A in that they immediately give rise to the creation of new or additional assets.

20. A key point is to **highlight M&A in FDI statistics in order to calculate the share of greenfield investments and extensions of capacity as residual**. It is relatively easy to identify M&A transactions because the majority of these operations are announced in financial press and electronic news services. The identification of greenfield investments and extensions of capital is much more complicated: clear definitions and a description of the concepts and the coverage are not available and there are no agreed standards on them.

21. It is important to note that the purpose of this study is not to measure the total volume of cross-border M&A transactions involving a resident company. According to their type of financing, some M&A transactions will be identified in the FDI statistics and some others will not. The value of the M&A identified in the balance of payments statistics may be very different from the total value of the M&A for the same reason: the following M&A data reflect the value of direct investment flows recorded in the balance of payments that are associated with M&A activity and not necessarily the full value of the assets acquired.

2.1. Identification of the M&A transactions in the FDI statistics

22. The identification of M&A transactions in FDI statistics is based on the three following criteria:
    - the flow is recorded under direct investment in equity capital
    - the flow is greater than €150 millions
    - the flow is linked with a M&A transaction in the first counterpart country

23. First, the identification is **limited to the direct investment in equity capital**. Other capital flows may be associated with M&A transactions but they are not considered in the process of identification. The ultimate purpose of this study is to estimate the share of the M&A relatively to the share of greenfield investment, calculated as residual. This reasoning does not suit for the other operation because inter-company loans reflect much more transactions than M&A or greenfield investments. In other words, the difference between the total of inter-company loans and the loans advanced in order to finance M&A is not equivalent to the loans advanced in order to finance greenfield investment or extensions of capital.

24. For practical reason, setting a threshold appears to be necessary in the identification process. A comparison of data obtained with different levels on different periods of time has been done and the result for France is that a **€150 millions threshold** allows us to have representative data.

25. In order to be identified as an M&A transaction, the direct investment flow has to be **linked with an M&A in the first counterpart country**. In the simplest case, the direct investor itself purchases a foreign direct investment enterprise: this flow will be included in the direct investment data under the M&A sub-heading. The recording will be the same when the parent company (resident in the Country 1) finances a subsidiary (resident in the Country 2) through a capital increase in order that the subsidiary purchases another company resident in the same country (i.e. the Country 2).

26. An interesting case is that where a subsidiary (resident in Country 2) of a direct investor (in Country 1) is used as a conduit by its parent to acquire a firm in the Country 3. In such cases, the parent company often provides the capital needed to acquire the target company. If it is clear that the transaction between the countries 2 and 3 has to be recorded under the M&A subheading, the classification of the transaction between the parent company and its acquiring subsidiary is not so obvious.

27. To illustrate, consider the following case:

Parent company:	Company A in Country 1
Acquiring company (subsidiary of A):	Company B in Country 2
Target company:	Company C in Country 3
Seller company:	Company D in Country 4

    The value of the target company is 100. To finance this operation, Company A makes a capital contribution of 100 in Company B, which takes over the Company C.

28. If the capital moving from the parent to the subsidiary would be considered as an M&A investment, the same M&A transaction would be recorded twice: first between the countries 1 and 2, and secondly between the countries 2 and 3. There would be an overestimation of the M&A transaction at a global level. When the capital increase between the parent company and its acquiring subsidiary is not considered as an M&A investment, the recording in the balance of payments of the different countries is the following:

	Country 1	Country 2	Country 3	Country 4
Direct investment abroad				
Equity capital excluding M&A	-100			
Equity capital: M&A		-100		+100
Direct investment in the reporting economy				
Equity capital excluding M&A		+100		
Equity capital: M&A			+100-100=0	

2.2. Results of the estimation

29. The estimation has been carried out over the past six years and the findings are presented in the table below:

Table 1: Share of M&A in equity capital transactions

(EUR billions)

	12-month cumulated figures ending						9-month cumulated figures ending	
	Dec. 1999	Dec. 2000	Dec. 2001	Dec. 2002	Dec. 2003	Dec. 2004	Sept. 2004	Sept. 2005
Outward FDI	**-119,1**	**-192,6**	**-97,0**	**-53,6**	**-47,1**	**-38,5**	**-30,2**	**-40,0**
Equity capital excl. M&A	-24,1	-35,1	-19,7	-26,6	-6,5	-16,4	-10,0	-2,8
Equity capital: M&A	-58,2	-116,0	-41,2	-14,8	-5,3	-6,4	-6,3	-9,2
Reinvested earnings	-11,7	-7,8	-0,4	9,6	-1,7	-3,9	-2,9	-3,6
Other capital	-25,0	-33,7	-35,6	-21,7	-33,6	-11,8	-10,9	-24,3
Inward FDI	**43,7**	**46,9**	**56,4**	**52,1**	**37,7**	**19,6**	**14,1**	**29,3**
Equity capital excl. M&A	5,6	11,1	9,8	16,9	10,0	10,2	8,5	6,3
Equity capital: M&A	12,6	18,8	13,3	19,1	5,1	-5,7	-5,7	3,2
Reinvested earnings	1,8	2,6	-2,8	-4,8	-1,9	1,1	0,8	1,4
Other capital	23,7	14,5	36,2	20,9	24,5	14,0	10,5	18,5

30. It is possible to draw at least three lessons from the table:
- After having accounted for a large share of direct investment in the early 2000s, M&A activity has receded in recent years and was outstripped by greenfield investment and extensions of capacity in volume terms from 2002 in the case of outward direct investment and from 2003 in the case of inward investment. In 2005 however, the M&A activity should rise, particularly for outward FDI.
- Equity capital transactions involving greenfield investments and extensions of capacity remained relatively stable during the period under consideration: they amounted to roughly €20 billion for French direct investment abroad and €10 billion for foreign direct investment in France.
- The fall in inward direct investment recorded in 2004 can partly be ascribed to equity capital divestment involving M&A transactions, given that equity capital investment in the form of

greenfield investment and extension of capacity remained stable. It can be also attributed to a decline in inter-company loans recorded under other capital.

2.3. Differences with M&A data compiled by private commercial data sources

31. To conclude, it is interesting to compare French flows of direct investment M&A as compiled by Banque de France and a private database (Thomson Financial). The overall results (see charts 1 and 2 below) for M&A in equity capital show a similar pattern as the aggregates compiled by Thomson Financial and the correlation is relatively satisfying between the two data series. However, M&A statistics sometimes differ drastically for both inflows and outflows: the most extreme case is in the year 2000 where the annual M&A outflows reported by Thomson Financial greatly overstates b.o.p. estimate, at around €79 billion.

32. Many reasons explain these large differences: first, **time of recording** is different. In the b.o.p. statistics, data are recorded at the closing date of the transaction whereas transactions are recorded as soon they are announced in the private databases. To illustrate, we can compare the value of correlation between both series when they are compiled on a monthly, quarterly or annual basis: as expected, the quality of the correlation improves with the horizon of time (see the table below).

    Table 2: Value of the correlation coefficient between flows of M&A compiled by Banque de France and Thomson Financial according to data frequency

	Data Frequency		
	Monthly	Quarterly	Annual
M&A outward flows	84,6%	91,5%	99,4%
M&A inward flows	66,1%	72,9%	76,6%

33. In our estimate, the **data coverage** is limited to the direct investment flows in equity capital. In private databases, there is no distinction along the line of the international FDI definition and the 10% threshold is not applied. Besides, recording an M&A transaction in the balance of payments depends on the way in which the operation is financed. When a group acquires a foreign company through a subsidiary resident in the country of the target firm, and when the subsidiary opts for a local source of financing (for e.g. by borrowing from the banking system of the country of the target company), the M&A will not give rise to any balance of payments flow.

34. Because M&A transactions involve the transfer of ownership, a given transaction can simultaneously give rise to a flow in one direction (investment by a non-resident acquirer) and in the opposite direction (divestment by the non resident seller). Both of these flows are recorded in the balance of payments, whereas the specialised databases only record the **gross** amount of the transaction (divestments are not recorded as such).

35. An M&A transaction involving two resident companies (and therefore not considered as a cross-border transaction) can even result in a direct investment flow in the balance of payments. If a resident group acquires another resident company, partially owned by a non resident owner, the inward divestment will be identified as a transaction linked with the M&A.

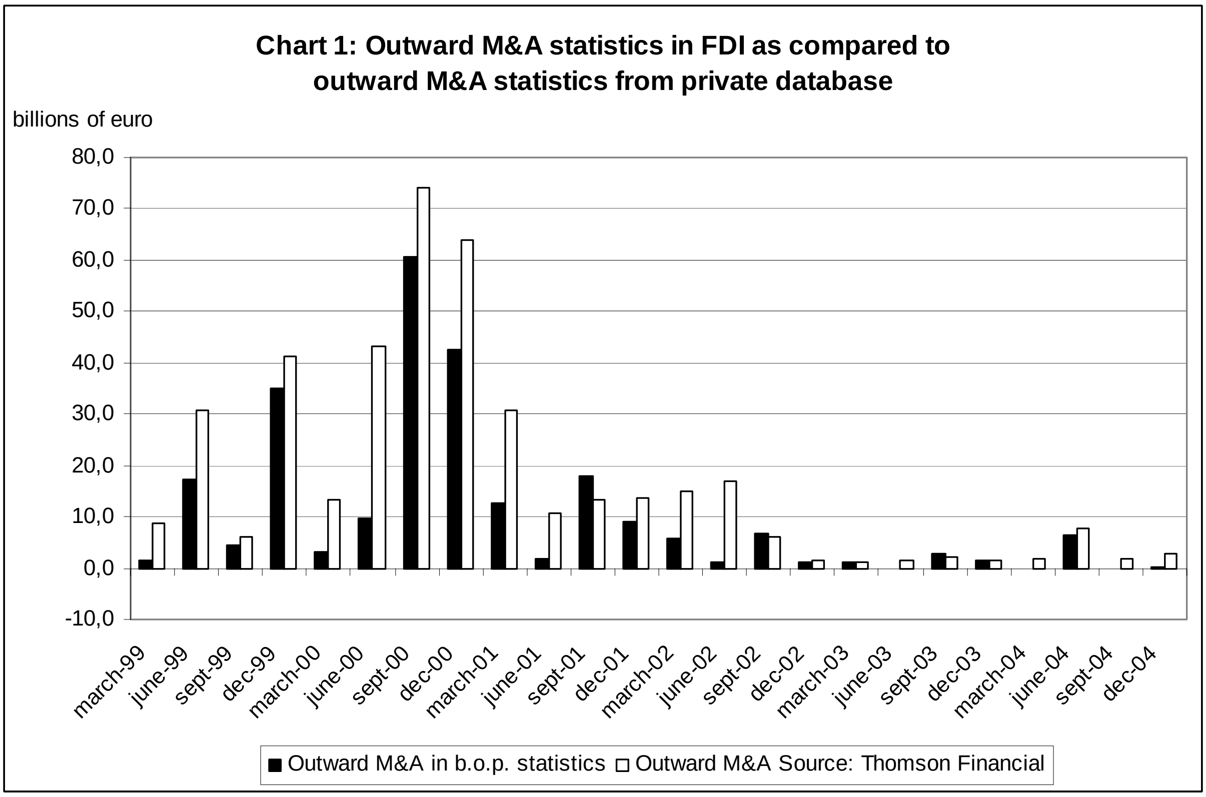
Chart 1: Outward M&A statistics in FDI as compared to outward M&A statistics from private database
billions of euro
80,0
70,0
60,0
50,0
40,0
30,0
20,0
10,0
0,0
-10,0
march-99
june-99
sept-99
dec-99
march-00
june-00
sept-00
dec-00
march-01
june-01
sept-01
dec-01
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june-02
sept-02
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march-03
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dec-04
Outward M&A in b.o.p. statistics
Outward M&A Source: Thomson Financial

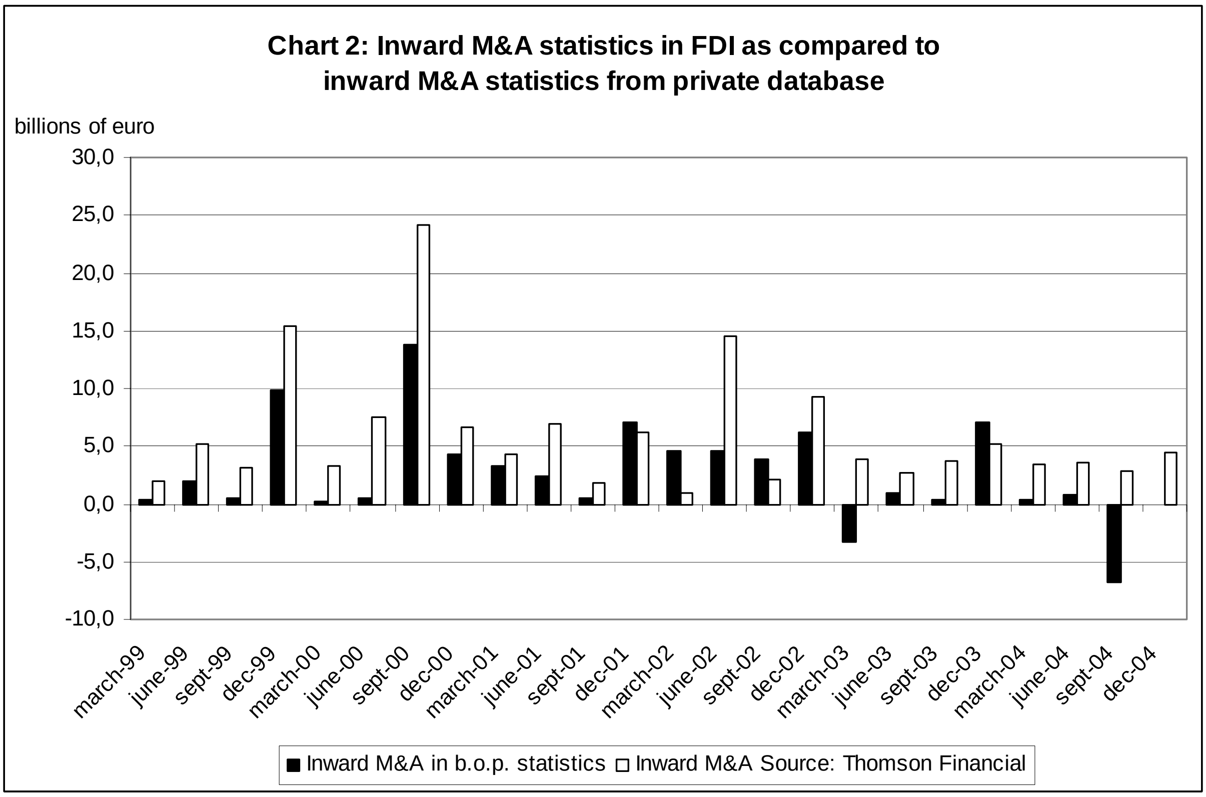
Chart 2: Inward M&A statistics in FDI as compared to inward M&A statistics from private database
billions of euro
30,0
25,0
20,0
15,0
10,0
5,0
0,0
-5,0
-10,0
march-99
june-99
sept-99
dec-99
march-00
june-00
sept-00
dec-00
march-01
june-01
sept-01
dec-01
march-02
june-02
sept-02
dec-02
march-03
june-03
sept-03
dec-03
march-04
june-04
sept-04
dec-04
Inward M&A in b.o.p. statistics
Inward M&A Source: Thomson Financial