WACHTELL, LIPTON, ROSEN & KATZ

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To Our Clients

The attached editorial from the "Financial Times" is a most cogent summary of the fundamental policy considerations with respect to takeovers. I commend it to your reading.

M. Lipton

Attachment

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Sir Hector or Lord Hanson

THE NOTION that big corporate takeovers are the business only of the shareholders directly concerned was always a convenient fiction—a piece of accounting folklore. With merger fever at its present pitch in Britain, public concern about the lightning deals being struck almost daily in the City seems fully justified. The concern is heightened because the shuffling of corporate assets is taking place against a backdrop of extremely frothy share prices. People have only to think of the parallels with the early 1970s to wonder whether the revived fashion for mergers makes long-term economic sense.

Many of the most hotly debated issues, including management style, the importance of size and the appropriate length of corporate and institutional time-horizons, are raised in the struggle for control of Imperial Group, the tobacco-to-brewing company. The adversaries in this £2.8bn takeover battle are Sir Hector Laing of United Biscuits, the food and restaurants group, and Lord Hanson of Hanson Trust, the industrial conglomerate.

Strongly patriotic

Sir Hector and Lord Hanson are closely identified with their companies' past successes; both are strongly patriotic and keen that Britain prosper in international markets. Yet they seem to have quite different conceptions of what a company is and where its main responsibilities lie.

Lord Hanson embodies what accountants term the "proprietary" approach to a company; Sir Hector the "entity" approach. The essence of the proprietary approach is that companies are in business to make money, not things. The shareholder is sovereign and the managers' principal duty is to make the largest possible return on capital; no strong distinction is drawn between so-called "organic" growth and expansion through acquisition; no particular effort is made to stay in or dominate particular markets.

The entity approach, by contrast, takes the short-term demands of shareholders less seriously. Managers are encouraged to look to the need of employees and the wider community. The function of business is seen as providing real goods and services: this requires specialisation. There is an emphasis on the need for long-range planning; financial ratios may have to take a back seat as management insists on measures that will not boost earnings per share in the short run.

In principle there is much to be said for the entity approach. It corresponds more closely to the economist's than the financier's view of the world. It rationalises the gut reaction of many industrialists that companies do better when they specialise and concentrate on producing a comparatively small range of goods. Most of the world's most-admired large companies started as small speciialists and grew because they were so efficient; they are not diversified conglomerates.

Larger questions

Certainly the UK needs companies, of which ICI is an example, which are world leaders in their industry, and it is arguable that Sir Hector Laing's management philosophy is more likely to bring about such a result than that of Lord Hanson. It is also true that conglomerates tend in the end to run out of steam—though whether that will happen in five, ten or 15 years' time is hard to predict. Yet United Biscuits, in bidding for Imperial, is also engaged in large scale diversification; the resulting group, though mainly concerned with consumer products, would be decidedly conglomerate in character. Experience over the last two decades suggests that claims about industrial "synergy" between, say, beer, biscuits and restaurants, need to be treated with caution; many big mergers produce disappointing results.

Thus it is hard to see any compelling "national interest" argument for the bid to go one way rather than the other; shareholders have to decide which of the bidders would manage Imperial better. Yet the larger question which underlies this and other takeover battles is whether the pursuit of size is being carried to lengths which will in the end have damaging consequences, not least for shareholders. Size is no guarantee of profitability or competitiveness; giant take-overs represent a high-risk strategy for corporate growth. A greater degree of modesty on the part of managers and their advisers would be in order.

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