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The Cost of Geopolitics to M&As

When geopolitical relations between nations are strained, states are more inclined to intervene to block mergers and acquisitions on national security grounds. But this makes mergers more difficult and more expensive, putting them at odds with the national interest.

M&A-induced protectionism is rising and not only in countries where state intervention is fairly common (such as France, Russia, Germany and Japan), but also in Anglo-Saxon countries such as the United States.

Cross-border deals involving US companies, which represented 40% of cross-border acquisitions in 2015, has raised protectionist concerns, most notably in deals involving Chinese acquirers. Geopolitical tension between the United States and China is not restricted to the South China Sea but has reached Wall Street's corridors.

With the forthcoming presidential election, Chinese acquirers, notably those targeting high-tech targets, are being closely watched by the Obama administration and Congress. Many in Washington consider these companies to be wings of the Chinese government as they are either owned or are connected (or suspected to be connected) to the latter. In some cases they are considered a threat to the country's national security and their overtures to corporate America are routinely blocked.

In February 2015 the Dutch company Philips learnt this lesson the hard way. In a move to focus more on the group's medical activities its management decided to sell its lighting subsidiary, Lumileds. A consortium of Asian companies was interested in acquiring Lumileds and made an offer that totalled more than US$3 billion. However, it was not to be. The Committee on Foreign Investment in the United States (CFIUS) a body made up of representatives from the US Treasury, the Departments of Justice and Defence blocked the takeover claiming it was a risk to US national security. Chinese investors were part of the consortium and it was feared that they would gain access to sensitive technology through the transaction.

Another recent case is the US company Fairchild Semiconductor International, that recently rejected a purchase proposal from the Chinese company, China Resources Microelectronics, despite a lucrative offer of approximately US$2.5 billion. The risk of being flunked by CFIUS was considered just too great by Fairchild Semiconductor International's team. The company operates in the semiconductor sector with its products used in some military equipment (such as drones).

National good vs. entrenched interests

The existence of geopolitical friction is not limited to Chinese-US transactions. It is common that target countries resort to different economic levers such as national champion-promoting policies to oppose a cross-border acquisitions or to obtain more favourable deal conditions for the target country.

Such M&A protectionism prevents the risk of nationally beneficial high-tech assets being acquired by foreign countries. Countries such as the US can maintain their edge in foreign affairs by maintaining technological superiority and preventing military-industrial arms races. Public intervention can also protect jobs and keep innovation at home. For corporations, this can ensure the continuity of good corporate governance that could be changed by a less developed foreign acquirer. It can also be beneficial to the target's shareholders. When international relations are strained, target companies are also better equipped to defend themselves against an acquisition that is deemed unfavourable, through the intervention (or the threat of intervention) from public authorities. This also leads to increased bargaining power during any negotiations that may follow.

A recently published article in the Strategic Management Journal by Olivier Bertrand and Marie-Ann Betschinger, management researcher at the University of Fribourg, Switzerland, found an inverse relationship between acquisition prices and the quality of international relations between countries. Their study looked at the operations of 700 large-scale international M&As from 1990-2008. It shows the purchase premium offered to a target company's shareholders may increase by 25% when bilateral relations between the countries of the purchaser and the target firm are strained.

The extent of state intervention

This raises the question of how much a state should intervene in M&A. It boils down to the fundamental question of the role of the state in a market economy. The state may intervene arbitrarily because of lobbying pressures and entrenched domestic interests, which is not viable in the long run. What is key for the state is to ensure a well-functioning market for corporate control that can attract both domestic and foreign investors. If the rules lack clear scope, it will make it difficult to predict whether a cross-border deal is likely to be blocked or require modification. We know that what foreign investors value most is institutional predictability. Lack of clarity will eventually dampen their enthusiasm. Investors need to know early on whether the proposed deal involves strategic assets likely to be subject to more stringent controls and whether these may have an impact on the deal's value or execution.

During the international mergers and acquisitions process therefore, the acquiring companies should consider the geopolitical dimension well in advance to avoid such pitfalls. The stakes will be much higher if there is political friction between the countries of the purchasing company and the target company. Not only will the purchase premium rise but so will the risk of the transaction failing or being altered with, for instance, required subsequent divestitures or job protection guarantees.

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