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MERGING INTO WEALTH?

The effect of foreign takeovers on the performance of domestic firms

Company takeovers are a highly sensitive topic, even more so if they are initiated by a foreign firm attempting to gain control over a domestic enterprise. In such cases, trade unions and governments, who fear the loss of domestic jobs, tend to call for the imposition of measures to limit such acquisitions. Such restrictive policies are notwithstanding most governments' official commitment to the free movement of capital, especially between members of the European Common Market. However, a closer look at the actual consequences of foreign takeovers on domestic firms in Germany reveals how thin the economic rationale for such intervention is in reality. Our research demonstrates that foreign acquisitions do not usually lead to job relocation and that, if anything, their actual economic effect is mostly overstated.

Both supporters and opponents habitually assume that foreign takeovers entail substantial consequences for the target company and its workers. Opponents argue that multinationals have an incentive to save fixed costs by reducing overheads in the acquired firm. This may then entail cuts in the domestic work force or even the closure of entire departments or production facilities. Consequently, most states have erected different types of formal or informal barriers to foreign takeovers, especially to protect firms in key sectors of the economy. A prominent example of such a restriction is Germany's so-called «Volkswagen Law», a piece of legislation that effectively blocks any takeover of the country's flagship automobile producer. Such policies are heavily criticized by supporters of free capital mobility, who point out that multinationals are usually more productive and exhibit a higher degree of knowledge capital than domestic firms. A domestic firm might then benefit from transfers of advanced technologies, novel management methods and synergies with the new multinational parent company. All of these factors would make firms significantly more productive after having been subject to a foreign takeover.

The foreign ownership premium

A first glance at the facts lends some credibility to the supporters' premise that there are indeed substantial differences between firms in domestic and foreign ownership. In Germany, where some of the most complete datasets are available, 7% of employees worked in foreign-owned firms in 2007, although these only represented 3% of all companies in Germany. Clearly,

foreign owned firms are on average larger than domestically controlled ones. In addition, they also tend to be more productive: value added per employee, which amounts to almost 90,000 Euro in foreign owned firms, is 37% lower in domestically owned firms. Consequently, foreign owned firms pay wages that are on average 330 Euro higher per month per employee.

A more sophisticated quantitative analysis reinforces these conclusions to a large degree. Regressing key performance indicators such as productivity, workforce size and export intensity against the ownership structure based on a broad panel of German firms allows to directly measure the "foreign ownership premium".

Even if we statistically take into account the possibility that foreign takeovers might disproportionately target certain industries, which may be inherently more productive, the results show that the foreign ownership premium can be substantial. In terms of workforce size, foreign owned firms are 236% larger, their labor productivity is 66% higher and their export intensity is 16% higher. So far, the supporters of foreign takeovers seem to be vindicated.

Cherry picking?

Yet the evidence on the foreign ownership premium, although it offers interesting insights, does only display half of the truth. So far, the results have only established correlation, not causation. After all, it could be that foreign multinationals specifically target more productive firms for takeovers by "cherry picking", without these firms becoming any more productive *after* takeover. Conversely, multinationals could prefer to purchase firms with a particularly low rate of productivity, as these offer the greatest scope for improvement. Such a strategy is known as the picking the "lemons". If the actual effect of a foreign takeover is to be reliably estimated, we need to understand which types of firms are actually acquired by foreign enterprises and how their performance indicators change afterwards.

First, do foreign firms pick the "cherries" or the "lemons"? To answer this question, we analyse the performance of 352 German firms that were subject to a foreign takeover between the years 2000 and 2007. Using a probabilistic regression model, we specifically test how different firm characteristics affect the probability of being acquired by a foreign firm.

The results indicate that both cherries as well as lemons are targeted. It is the firms with average productivity that apparently are least attractive for foreign investors, presumably because they offer neither significant scope for improvement nor for readily exploitable profits. Conversely, high turnover and strong export intensity have a linear positive influence on the probability of a foreign takeover. The fact that especially firms with a high export intensity are targeted would indicate that foreign multinationals are partly motivated to engage in foreign acquisitions in order to develop new markets.

Establishing direct causality

Second, we estimate how firm performance changes after a takeover. As the results of the previous sections demonstrate that there is no clear linear connection between productivity and the probability of being acquired, a more advanced method of determining causality is needed.

We therefore turn to a method similar to those used in medicine. The basic idea of this "matching approach" is to compare the performance of a treatment group, whose members were subject to a particular event, against the performance of a control group, whose circumstances did not change in the same period of time. More specifically, for each firm that was acquired by a foreign company between 2000 and 2007, we find a so-called "twin" firm that was not acquired as a control benchmark. Apart from the differing ownership structure, this twin firm has to exhibit the same characteristics in terms of size and industry as the firm that was acquired. This way, the causal effects of a foreign takeover which are not biased by differing underlying firm characteristics can be successfully isolated.

The results show that the difference between acquired firms and the control group is very small, and in most cases not statistically significant. In terms of employment, neither negative nor positive effects can be discerned within an average of two years after the takeover. This indicates that, contrary to popular wisdom, multinational firms to not regularly cut jobs in firms that they acquire. On the other hand,

similar conclusions hold true for productivity: newly acquired firms do not seem to become more productive after a takeover. Other variables such as sales, average wages and salaries, as well as labor productivity, exhibit no significant deviations between the treatment and the control group either.

A different picture emerges, however, regarding export intensity. On average, newly acquired firms increase the share of sales they generate from export activities by about 2.7 percentage points after a foreign takeover. This implies that foreign investors do indeed acquire firms for market expansion.

Conclusion

Contrary to the claims of opponents of foreign takeovers, we find no significant negative effects on employment of German firms resulting from cross-border acquisitions. In the same vein however, we find claims by proponents of foreign acquisitions predicting vast increases in productivity to be overstated. In reality, there seems to be relatively little that changes in a company's performance as measured by most conventional performance indicators, including sales and wages, after a takeover.

These results have direct implications for the design of policies aimed at restricting foreign takeovers. Given that our analysis has shown that foreign takeovers do not seem to entail any negative effects for domestic firms, the rationale for such restrictive measures seems to be questionable. Indeed, as export intensity is the one variable that generally increases after a takeover, restrictions would be endangering a more international orientation of firms.

It might therefore be that present concerns about cross-border acquisitions are unnecessary from an economic point of view, and that policy actions based on such concerns may potentially have unintended consequences. This becomes even clearer from the perspective of the European Single Market, for whose success the free and unrestricted movement of labor, goods and capital across national borders is an absolute requirement. It would surely not be intended to endanger this keystone of European integration for the sake of concerns, which, as this analysis has demonstrated, lack sufficient empirical validation.

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- Forecasting future energy demand
- Assessing market regulations (third party access, licensing, competition, tariff setting)
- Strategic advice on market positioning
- Impact analysis of tax reforms
- Evaluation of labour market policies

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How to contact us

DIW econ GmbH
Mohrenstrasse 58
D-10117 Berlin
Germany

www.diw-econ.de
service@diw-econ.de
Tel. +49 30/20 60 972-20
Fax +49 30/20 60 972-99